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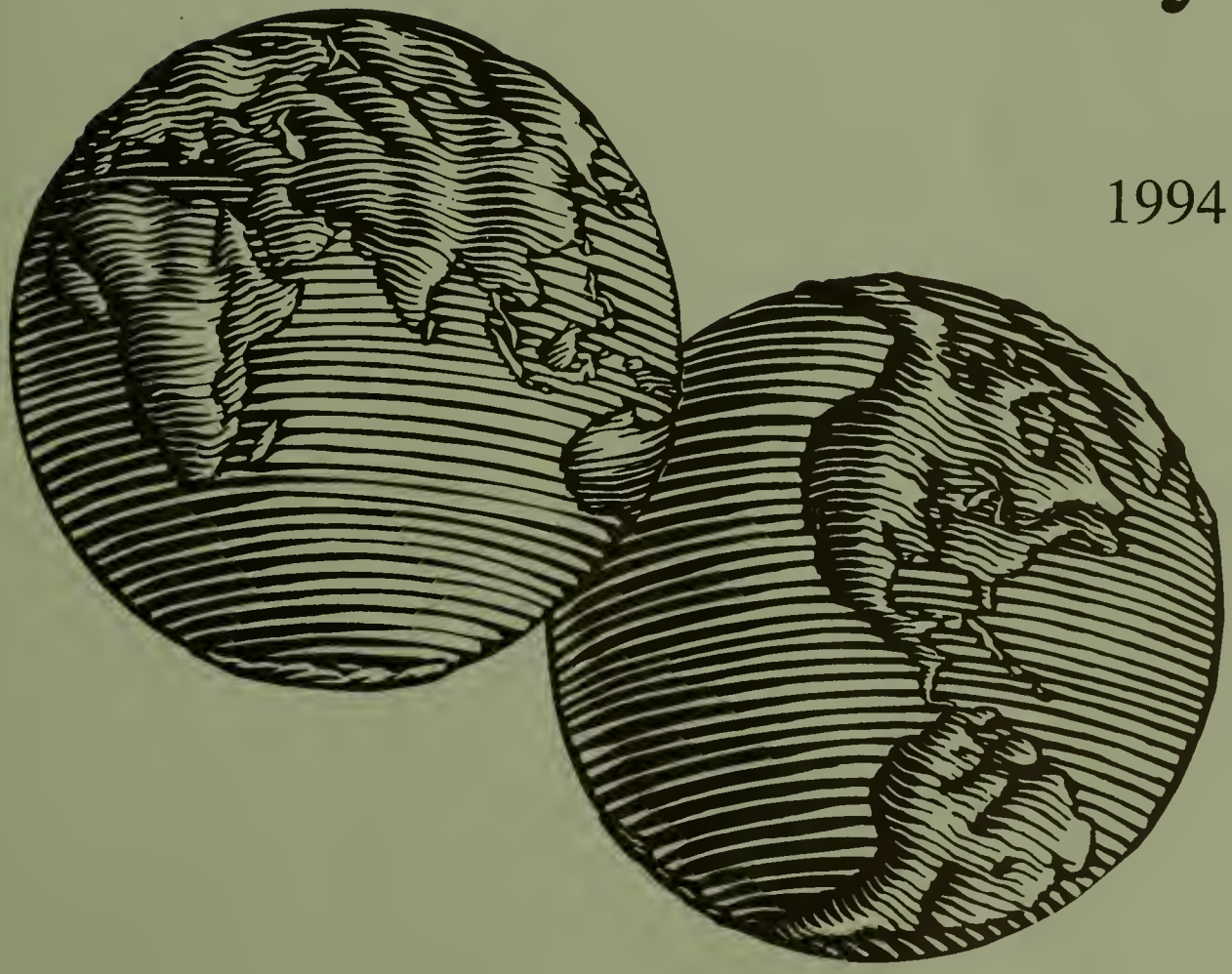
National Treatment Study

1994



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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1994

The Honorable Al Gore
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

Pursuant to the Financial Reports Act of 1988 (Pub. L. 100-418, sec. 3601 et seq.; 22 U.S.C. 5351 et seq.), I am pleased to submit the "1994 Report on Foreign Treatment of U.S. Financial Institutions." This Report updates and expands upon the National Treatment Studies completed by the U.S. Treasury in 1979, 1984, 1986, and 1990. The 1994 Report examines the degree of national treatment and market access afforded U.S. financial institutions in thirty banking and thirty-two securities markets, and under the Financial Services Directives of the European Union. The Report also describes U.S. Government efforts to remove barriers to trade in financial services and reviews the presence and treatment of foreign financial services firms in the United States.

Intensive multilateral and bilateral negotiations have led to significant improvements since the last report in the terms on which U.S. firms compete in offering financial services abroad. The North American Free Trade Agreement (NAFTA), which includes important commitments on financial services, has entered into effect. The European Union's single market in financial services is being implemented on the basis of reciprocal national treatment. Bilateral negotiations with Japan, China, Korea and Taiwan have yielded progress in a number of key areas. Uruguay Round negotiations on financial services have produced interim commitments that could give U.S. firms more secure access, and in some respects better access, to some foreign markets.

Despite these improvements, lack of national treatment and lack of equality of competitive opportunity is still too prevalent in too many important markets, and in a number of commercially-important markets, the rule rather than the exception. This Report describes those problems in detail. The United States is continuing its efforts in the GATS to negotiate commitments that open financial markets and provide national treatment in those markets on an MFN basis. Bilateral negotiations with Japan, China, Korea and Taiwan have been intensified in the context of the Uruguay Round, providing helpful impetus to the multilateral process.

Sincerely,

Lloyd Bentsen

Lloyd Bentsen

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1994

The Honorable Thomas S. Foley
Speaker of the House of Representatives
Washington, D.C. 20515

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Lloyd Bentsen

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PREFACE

The 1994 National Treatment Study is the second quadrennial report required by the Financial Reports Act of 1988 (Pub. L. 100-418, sec. 3601 *et seq.*; 22 U.S.C. 5351 *et seq.*) (Reproduced in Appendix I). The first report required under this act was prepared in 1990.

The Office of the Assistant Secretary for International Affairs (OASIA) of the U.S. Treasury Department and the Office of the Comptroller of the Currency (OCC) share responsibility for the preparation and production of the entire report. (Appendix II, Acknowledgments, indicates the principal authors and editors of individual chapters.)

The 1994 National Treatment Study begins with an Executive Summary that gives an overview of the entire report. The main body of the study is divided into three parts. Part I describes the treatment of foreign financial institutions under U.S. law and the operations of foreign financial institutions in the United States. It contains two chapters that cover the banking, securities, and insurance sectors, including futures and other derivatives markets. Part II describes international financial services negotiations that have been, and are currently being, undertaken by the U.S. Treasury Department. It includes chapters on the Uruguay Round and NAFTA. Part III reports on the treatment of U.S. financial services firms in overseas banking and securities markets. It begins with a Synopsis, followed by detailed descriptions of market conditions in 33 countries and regions. The chapters are grouped geographically. Some countries are included in a National Treatment Study for the first time.

The country chapters cover major markets in which U.S. financial services providers confront significant impediments to the establishment or provision of financial services. However, the report also encompasses markets where significant improvements have taken place since the 1990 National Treatment Study and, for benchmark purposes, some markets that have not been included in previous reports on national treatment. The Treasury Department and the OCC solicited private sector views about which markets should be studied through a notice in the September 14, 1993, *Federal Register*, and these chapters reflect the comments received. Also, drafts of the chapters were sent to financial and regulatory authorities in each market for review. The final report reflects the views of the U.S. Treasury Department.

The study covers both the banking and securities markets in 30 countries, and securities only in two additional countries. One chapter describes in detail the directives implementing the European Union's single market in financial services. There also is a consolidated chapter covering nine countries of the European Union (EU) and the European Free Trade Area (EFTA), focussing on the implementation of the EU directives at the national level. With the exception of the EU and EFTA chapters, each country chapter follows the same basic format: summary, description of the market, the presence of U.S. financial institutions, and the treatment of U.S. financial institutions. The China, Japan, Korea, and Taiwan chapters also include sections describing bilateral discussions between the U.S. Treasury and the finance authorities in these markets and the progress that has been made in the talks.

This National Treatment Study is current as of June 30, 1994. Where possible, developments since that date have been incorporated.

EXECUTIVE SUMMARY

Current conditions are quite different than they were four years ago when the 1990 National Treatment Study was completed. International trade in financial services has taken on much greater significance. Intensive multilateral and bilateral negotiations have led to significant improvements in the terms on which U.S. firms compete in offering financial services abroad. An historic North American Free Trade Agreement (NAFTA), including important commitments on financial services, was concluded and has entered into effect. The European Union's single market program in financial services is being implemented and expanded geographically. Bilateral negotiations on financial services with Japan have continued in the context of the U.S.-Japan Framework for a New Economic Partnership with the objective of achieving a comprehensive agreement that can contribute to the successful conclusion of the General Agreement on Trade in Services (GATS) negotiations. Uruguay Round negotiations on financial services, although not concluded, have produced interim commitments that could give U.S. firms more secure access, and in some respects better access, to some foreign markets than they had before. The principal negotiating objective of the United States in the extended negotiations on financial services is to achieve substantially full market access and national treatment in commercially important countries.

There also have been several major developments in U.S. financial legislation and regulation. In the banking area, the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) strengthened U.S. bank regulators' authority to regulate and supervise the activities of foreign banks in the United States. Among other measures, the statute includes a prudential provision that all foreign bank applicants seeking to establish branches and agencies must be subject to comprehensive consolidated supervision by their home country authorities. In September 1994, the Congress enacted, and President Clinton signed into law, the Interstate Banking and Branching Efficiency Act of 1994, a major step forward that should facilitate greater geographic diversification in the U.S. banking system. The act provides domestic and foreign banks with nationwide banking opportunities.

In other financial services, U.S. regulators have taken a number of steps to simplify access to U.S. securities markets by foreign firms and issuers, without compromising investor protection. The Securities and Exchange Commission (SEC) has modified and simplified certain disclosure requirements that facilitate access to U.S. capital markets, including accepting, for the first time, cash flow statements prepared in accordance with international accounting standards. A total of 305 new foreign corporate issuers have entered the U.S. markets since January 1990, including companies from Germany, China, Chile, Venezuela, and Brazil. In addition, under Rule 144A, introduced in April 1990, resales of certain restricted securities have been exempted from SEC registration requirements; nearly half of the 514 issuers or guarantors under this rule have been foreign. Also, since 1992, the SEC has eased restrictions on foreign advisers to provide further incentives for foreign advisers to provide services to U.S. clients. The Commodity Futures Trading Commission (CFTC) has implemented measures to facilitate 24-hour trading of U.S. and foreign exchange-traded products on approved electronic trade

execution systems and has continued to improve U.S. customer access to foreign risk management instruments by exempting from CFTC regulations foreign firms that are subject to "comparable" regulatory schemes by home country authorities.

These developments in the U.S. market preserved national treatment for foreign financial institutions. Where new opportunities were created, they were extended on an equal basis to foreign and domestic institutions. Where new prudential standards were established, they have been applied on a national treatment basis.

During this period, both houses of Congress passed bills designed to reinforce the administration's efforts to encourage further liberalization of foreign financial markets. Both the proposed Fair Trade in Financial Services (FTFS) Act, which passed the Senate in March 1994, and the more narrow National Treatment in Banking Act, which passed the House in September 1994, would have provided discretionary authority to limit the opportunities afforded in the United States to financial institutions from countries that deny national treatment and market access to U.S. financial institutions. Neither bill became law.

Foreign financial institutions continue to maintain a large and diverse presence in the United States. As of June 30, 1994, 288 foreign banks from 60 countries operated 580 agencies and branches, 91 banking subsidiaries, 12 Edge corporations, and six New York State Investment Companies. Foreign banks' U.S. affiliates' share of total U.S. banking assets was 21.0 percent, including 32.7 percent of business loans. SEC staff has identified the number of foreign persons that have equity interests of 25 percent or more in registered broker-dealers to be approximately 173, out of a total of about 8,000 registered broker-dealers in the United States. In 1993, foreign-owned broker-dealers lead-managed 149 bond issues in the United States totalling $35.1 billion, and 33 equity issues totalling $2.2 billion. In addition, there are roughly 312 foreign investment advisers (up from approximately 200 in 1990) registered in the United States and 127 foreign firms that are permitted to engage in commodity futures and options brokerage activities.

IMPROVEMENTS IN NATIONAL TREATMENT ABROAD SINCE THE 1990 REPORT

In a number of foreign markets, progress has been made since the 1990 National Treatment Study to expand the opportunities afforded to foreign financial institutions. National laws and regulatory practices have been amended as countries recognized the importance of foreign participation in creating deeper, more efficient capital markets. The general embrace throughout most of the emerging markets of economic reform and liberalization provided impetus to financial deregulation and liberalization. In many important instances, these changes were a direct consequence of negotiations or discussions between U.S. and foreign officials.

Significant developments since the last study include the following:

(1) The financial services chapter of the NAFTA entered into force, providing market access and national treatment for U.S. financial institutions in Mexico and Canada. The agreement also establishes a formal consultative group and a dispute settlement mechanism. For the first time in over 50 years, U.S. banks, securities firms and other types of financial intermediaries will be allowed to establish and operate in Mexico, subject to limits on market share during a transition period that ends January 1, 2000.

(2) The European Union has provided access to the single market in financial services on a reciprocal national treatment basis. The Second Banking Directive, which gives universal banking powers throughout the member states to locally incorporated subsidiaries, went into effect on January 1, 1993. The Investment Services Directive, which will expand the range of securities activities that locally incorporated subsidiaries may provide throughout the area, will go into effect on January 1, 1996. Early indications are that U.S. banks and securities firms established in the area are planning to take full advantage of the expanded business opportunities offered by the single market.

Direct branches of foreign financial services firms will continue to be subject to the regulation of individual member states. In some of these countries, branches of U.S. banks are subject to operating restrictions based on local capital that do not apply to branches of EU banks. Bilateral negotiations between U.S. regulators and their German counterparts resulted in substantial alleviation of local capital requirements for U.S. bank branches in Germany.

(3) Bilateral negotiations between the U.S. Treasury and financial authorities in Japan, China, Korea, and Taiwan have yielded substantive progress in a number of key areas.

In Japan, foreign investment trust management companies were permitted in 1990 to establish for the first time. Also in 1990, limited access was given to investment advisers, including U.S. investment advisers, to manage a small portion of private pension fund monies. (The percentage of eligible private pension fund money was expanded in October 1994.) The range of securities products that securities firms may now underwrite and sell in Japan has been expanded slightly. In addition, the long process of deregulating deposit interest rates, begun in the late 1970s, was completed in October 1994. Other improvements include expanded swap opportunities for securities firms, the addition of new derivatives products and bank licenses for securities firms.

In China, the number of permissible locations for foreign branch banking has been expanded to some extent and the Chinese authorities have committed to further liberalization. In addition, foreign banks may now buy and sell foreign exchange on behalf of foreign-invested joint ventures. Foreign financial firms also may participate in underwriting offshore securities issued by Chinese residents, and, for the first time, foreign securities firms may now establish representative offices in China. In addition, foreign securities firms may now provide brokerage services for a certain class of Chinese securities.

In Korea, progress was made to improve foreign banks' cost of funding. The Finance Ministry raised the limits on local currency funding that can be obtained through the issuance of certificates of deposit and agreed not to reduce swap lines without first consulting with foreign banks. Less restrictive rules also were adopted in the treatment of local capital for the purpose of establishing bank lending limits. Certain restrictions on foreign investment in Korean securities were eased; a further liberalization has been announced for 1995. Since 1992, foreign securities firms have been permitted to establish branch offices in Korea. In March 1992, the Ministry of Finance announced that Korea would formulate a three-stage "Blueprint" for comprehensive financial sector liberalization. Implementation of these measures is underway. In early 1994, Korea established an unofficial subcommittee to study and make recommendations on reform of the foreign exchange system. An announcement is expected by the Ministry of Finance before the end of 1994.

In June 1994, Taiwan partially lifted the ban on foreign investment in local banks. Soon afterward, Taiwan announced the easing of certain criteria for foreign bank branch entry, the immediate elimination of geographical and numerical restrictions on bank branching, and a reduction of the waiting period between establishment of an initial branch and additional branches from five years to two years. In addition, the ceiling on foreign banks' acceptance of local currency deposits was eliminated. (Previously, the limit on lending in local currency for a single customer had been relaxed for banks with capital above certain levels.) In addition, foreign securities firms may now establish subsidiaries or branches that can provide the same services as domestic securities firms. And restrictions on aggregate securities purchases by foreign institutional investors have been partially eased.

(4) As part of the recently completed Uruguay Round, a new General Agreement on Trade in Services (GATS) was adopted, establishing a framework of multilateral disciplines that can be applied to trade in financial services. These disciplines include market access, national treatment, and most-favored-nation (MFN) obligations. The United States conducted an intensive series of negotiations during the Uruguay Round with some 40 countries plus the European Union, which represented its 12 member states. The negotiations were aimed at securing binding commitments to the obligations of the GATS with few significant limitations. Sixty-one of the over 100 parties to the agreement made commitments under the GATS in the financial services area. Countries with developed and relatively open financial markets generally agreed to extend national treatment and market access in the financial services area. A limited number of other countries took modest steps toward that standard. Many others insisted on retaining severe limitations on market access and national treatment.

The following are illustrative of some of the more significant steps toward financial liberalization made since the GATS negotiations began. Argentina has eliminated legal impediments to foreign financial services firms establishing and operating in its market. Australia now allows branches of foreign banks to establish for wholesale banking business. Hong Kong recently eased limits on the number of offices that foreign banks can open for "backroom" operations. India has

liberalized, to some extent, entry for foreign bank branches; Pakistan recently allowed one U.S. bank to open new branches. The Philippines has opened itself to the establishment of new foreign banks for the first time since 1948 and allowed the establishment of universal banks. Venezuela has implemented legislation at the beginning of 1994 significantly expanding foreign banks' ability to enter that market. In many cases, however, these positive steps, some of which are very recent, remain to be incorporated in the countries' GATS commitments.

(5) Finally, financial services markets that hardly existed four years ago in several Eastern European countries have undergone significant development in which a role is being played by foreign financial services providers.

CONTINUING PROBLEM AREAS

Despite these improvements, significant denials of market access, national treatment and equality of competitive opportunity remain. This section describes a number of the more important impediments that remain in the banking and securities sectors.

Banking

In many areas of the world, resistance to the entry/establishment of foreign banks continues.

- Brazil's Constitution prohibits new entry of foreign banks and imposes a freeze on increases in foreign participation in the ownership of existing institutions.

- A number of other countries have formal moratoria on the issuance of new domestic (onshore) banking licenses. Often, these moratoria apply to both domestic and foreign banks, but the effect may fall disproportionately on the latter. Currently, these countries include Chile, the Czech Republic, Malaysia, Singapore, and Thailand.

- Some countries still prohibit entry via direct branches. Both Canada and Mexico maintain such a prohibition, an issue open to future negotiation under NAFTA.

- Others discourage branches, either *jure* or *de facto*, including Colombia, Hungary, Indonesia, Poland, Russia, and South Africa.

- In addition to prohibiting *de novo* foreign bank entry, Malaysia requires previously established foreign bank branches to convert into subsidiaries.

- Indonesia allows entry only in joint venture form, which precludes 100 percent foreign ownership. In addition, in order to establish these entities are subject to higher capital requirements than domestic counterparts.

- In some markets branches of foreign banks are allowed to enter, but then are subject to limitations on the number of additional branches, or are confined to a limited geographic area. Generally, the limits include off-site ATMs. Such restrictions are found in China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

- Narrow forms of reciprocity are applied by a number of countries. For example, in approving branch applications, India takes into account the number of Indian banks established in the applicant's home country.

- Certain countries prohibit foreign banks from participating in local currency business. This includes China, and in Russia a moratorium was imposed until January 1, 1996, on all foreign bank operations with Russian residents unless the bank was already servicing residents before the decree was issued.

- Some countries place global ceilings on foreign banks' share of total banking system assets. This list currently includes Canada, although U.S. and Mexican banks are exempted from the limits. (Canada will eliminate the ceiling effective on or before the date of establishment of the World Trade Organization.)

- A number of countries impose investment screening regimes that permit new establishment or expansion of operation to be refused at the discretion of the reviewing agency, with no or with overly broad criteria for refusal. These provisions are a matter of concern even when not used against U.S. firms. (Screening applies in the securities sector as well.)

After establishment, direct branches of foreign banks often face impediments to operation resulting from host country rules on capital. Limits on activities such as lending and foreign exchange positions may be tied to locally held capital rather than the parent company's capital. Because this requirement necessitates the expense of holding a large amount of capital locally, it in large measure vitiates the advantage of operating as a branch rather than as a subsidiary.

- In a number of European Union current and prospective member countries, local capital requirements still apply to branches of non-EU banks, but not to branches of banks of EU member countries.

- Other countries, including Brazil, Korea, and Turkey, apply burdensome capital requirements to foreign banks' operations.

In some markets, a high degree of concentration in the banking industry and official tolerance of restrictive practices by private banks work to the disadvantage of foreign banks.

- In Singapore, and Malaysia, foreign banks are not able to gain access to the ATM networks of local banks, and are prohibited from establishing their own networks.

Lack of transparency in the development and implementation of laws and regulations is still a serious problem in a number of countries.

Securities

In many securities markets, restrictions on entry/establishment continue to exist.

- In Brazil, the same constitutional prohibition on new entry and freeze on foreign participation that exists in the banking sector also exists in the securities sector.

- South Africa prohibits entry of foreign securities firms in any form other than unlicensed "nameplate" operations.

- In Malaysia and in Turkey no new brokerage licenses are being issued.

- China permits only representative offices as a general matter; however, one joint venture investment bank with U.S. participation was approved in October 1994.

- Some countries prohibit wholly foreign-owned securities subsidiaries. These include Korea, Malaysia, and Pakistan.

- In the Philippines, foreign firms can establish wholly-owned brokerages, but they can hold only minority stakes in firms with broader securities powers.

- In a number of cases, limits on foreign participation are especially tight for firms involved in mutual fund or pension fund management. This is so in Korea and Taiwan.

The establishment of foreign securities firms also can be impeded by discriminatory capital requirements.

- In Indonesia, joint ventures, the only means by which foreigners currently can enter the market, are subject to discriminatory capital requirements.

Various limitations may be placed on market share after establishment.

- In Japan, access by investment advisers to manage public and private pension funds is severely limited, even though other private financial institutions face no such legal obstacles.

Membership on stock exchanges may be necessary for full participation in securities markets. Access to membership on local stock exchanges may be unavailable or available only on an unfavorable basis, based on reciprocity, or subject to numerical limitation.

- Examples of this include Malaysia, Singapore, and Thailand.

Exchange controls and overall restrictions on foreign investment can have an important effect on the ability of U.S. firms to provide financial services. Limits may be placed on foreign access to securities listed on local stock exchanges, including ceilings on the percentage of foreign ownership, prohibition of purchases by foreign individuals, and ceilings on purchases by foreign institutional investors.

- Such restrictions exist in China, India, Indonesia, Korea, Taiwan, and Thailand.

Limitations on domestic capital market activities or cross-border capital flows, while generally applicable, may have a disproportionate impact on U.S. securities firms that are well-positioned to introduce foreign residents to U.S. financial services and products.

- In Japan, restrictive regulation on the issuance of corporate securities can limit underwriting opportunities for foreign securities firms. The Securities Exchange Law, and the manner in which it is administered, severely limit the scope of opportunity for foreign securities firms to introduce innovative new financial instruments.

- Japan also retains broad administrative measures on capital account transactions that have the effect of impeding market access for certain types of financial products.

FUTURE LIBERALIZATION — A THREE-PRONGED STRATEGY

The problems identified in this summary and described in greater detail throughout the study present major challenges for U.S. financial institutions. These challenges are particularly acute in the emerging markets. Although many countries have begun to recognize the economic benefits that come from liberalization of the financial sector, national treatment is still the exception rather than the rule in too many important markets.

The efforts of the United States to encourage further liberalization are concentrated on three areas. First, the United States is continuing its effort in the GATS to negotiate commitments that open financial markets and provide national treatment in those markets on an MFN basis. Second, this multilateral effort is reinforced by bilateral efforts in markets where the United States has particularly important interests. Third, the United States has undertaken a number of other initiatives to promote capital market development and integration in emerging financial

markets and to help build the regulatory infrastructure that must complement the liberalization process.

GATS

The extended negotiations on financial services in the GATS will continue through the first six months after the World Trade Organization is established. The United States will continue negotiations with commercially important developed and developing countries, including those discussed in this report. In these negotiations, the United States seeks binding commitments to reduce or eliminate barriers to national treatment and market access, within a clearly specified and reasonable period of time. Our objective is to achieve substantially full market access and national treatment for U.S. financial institutions in a broad range of commercially important developed and developing countries. This remains the condition for the United States to accept an MFN obligation on financial services under the GATS.

Intensive Bilateral Discussions

The Treasury Department has also been engaged for a number of years in bilateral financial market discussions with Japan, China, Korea, and Taiwan. These bilateral negotiations have been intensified in the context of the Uruguay Round, providing helpful impetus to the multilateral process. United States policy is that the results achieved in these negotiations should be extended to all countries on an MFN basis.

Other Initiatives

The United States also is engaged in a variety of other initiatives to encourage change that will lead to more developed and integrated financial markets around the world.

- In the World Bank and the regional development banks, the U.S. has promoted the development of investment and financial sector loans that encourage liberalization of barriers to foreign entry and participation.

- In the International Monetary Fund (IMF), the U.S. is supporting an effort to extend the discipline that now exists on exchange restrictions on current account transactions to the restrictions applied to capital account transactions.

- In the Organization for Economic Cooperation and Development (OECD), the United States strongly supported a major expansion of liberalization obligations covering financial services activities.

- In the regional context, the U.S. has promoted cooperative efforts by regulatory agencies to help develop the regulatory infrastructure necessary for further capital market deregulation and integration.

  — The U.S. is working with Latin American countries through the Summit of Americas to promote financial market development, capital market liberalization, and enhanced financial regulatory cooperation.

  — The first meeting of finance ministers from the Asia Pacific Economic Cooperation (APEC) forum was held in March 1994. At that meeting, the ministers agreed on the need to broaden and deepen local capital markets and to better mobilize domestic savings. They also discussed several issues of common concern as APEC members seek to develop their financial markets and to attract foreign capital.

NATIONAL TREATMENT UNDER U.S. LAWS AND REGULATIONS

INTRODUCTION

The prevailing policy of the United States has been, and continues to be, to provide national treatment to foreign investors in their establishment and operation of financial institutions within the United States. The adoption of a policy of national treatment by the United States arose from the conviction that competition in financial services is healthy and beneficial. The U.S. financial markets, U.S. borrowers, U.S. investors, and the economy as a whole have benefitted from the presence of foreign financial institutions. The openness of U.S. financial markets helps to reinforce U.S. efforts to encourage greater financial market liberalization in foreign countries that do not yet provide substantially full market access and national treatment.

The purpose of this chapter is to highlight changes in U.S. law and regulation since publication of the 1990 National Treatment Study that are relevant to the treatment accorded to foreign financial services firms. This chapter draws upon the 1990 Study in order to provide a context for discussion of new developments but, to the extent possible, it avoids repetition of material set out in previous studies.

This chapter is organized into seven sections, including this Introduction. The second section discusses the application of the principle of national treatment since the 1990 National Treatment Study. Section 3 examines the treatment accorded foreign banking organizations under U.S. banking law. Sections 4 and 5 provide parallel accounts of the treatment of foreign institutions active in U.S. securities and commodities markets. These sections also address regulations affecting the ability to introduce new products into the U.S. securities, options, and futures markets. Section 6 examines the key features of state insurance law, as the insurance industry is not regulated at the federal level in the United States. Concluding remarks appear in Section 7.

NATIONAL TREATMENT IN THE U.S. FINANCIAL SERVICES SECTOR

In the financial services area, U.S. policy has been to accord national treatment to foreign financial institutions under U.S. law and regulation. As practiced, national treatment accords substantially the same treatment to foreign financial institutions in the United States as is extended to U.S. financial firms in like circumstances. This ensures that national treatment affords equality of competitive opportunity to foreign financial institutions in the U.S. market. This approach provides a level playing field in the United States for foreign and domestic financial institutions. This chapter highlights the extent to which national treatment including equality of competitive opportunity in financial services has been expanded under U.S. law and regulation since 1990.

Assuring equality of competitive opportunity may in some cases require differential treatment of foreign financial institutions compared to domestic financial institutions. Providing identical treatment may not always be sufficient to ensure that foreign financial institutions enjoy equality of competitive opportunity in U.S. financial markets. Differential treatment is sometimes necessary in order to accommodate legal and regulatory systems and banking structures in foreign countries that may differ from those in the United States. Providing equality of competitive opportunity, therefore, sets a higher standard of fairness than *de jure* national treatment, based simply on identical treatment in law and regulation.

This same definition of national treatment has been the foundation of U.S. efforts to encourage other countries to liberalize their financial markets. As in the United States, identical treatment of foreign and domestic financial institutions may not always be sufficient to ensure equality of competitive opportunity in foreign markets.

Recent Developments in the United States

In the United States, national treatment traditionally has been extended unconditionally, while the U.S. has negotiated to secure improved market access and national treatment in foreign markets for U.S. financial service providers. Over time, the limited success of ongoing bilateral and multilateral efforts to obtain improved opportunities in foreign financial markets for U.S. financial firms has led to pressure in the United States to place potential conditions on the access accorded financial institutions from countries that discriminate against U.S. financial services providers. In 1988, for example, the U.S. enacted the Primary Dealers Act, which restricts designation of foreign-owned entities as primary dealers in the U.S. government debt market if their home country does not accord the "same competitive opportunities" in underwriting and distribution of government debt instruments to U.S. firms as it accords to domestic companies.

The Fair Trade in Financial Services Act

In 1990, and every year thereafter, the U.S. Congress proposed legislation that would have given the Executive Branch authority to limit access to the U.S. market for financial institutions from countries that discriminated against or denied national treatment to U.S. financial institutions. In October 1993, the Clinton administration formally endorsed the objectives of the Fair Trade in Financial Services Act (FTFS).

Under this proposed FTFS legislation, the Secretary of the Treasury, in consultation with the heads of relevant Executive Branch agencies and federal financial regulators, was required first to identify foreign countries that deny national treatment to U.S. financial institutions. Second, the secretary, again in consultation, was required to determine whether the denial of national treatment had a significant adverse effect on U.S. banks and securities organizations. Third, the secretary was authorized to enter into negotiations with countries that deny national treatment in an effort to remove such restrictions on the equality of competitive opportunity accorded U.S.

banks and securities firms. There was a similar Executive Branch process for insurance organizations. Fourth, if negotiations failed, the Secretary of the Treasury was authorized to publish a finding that a country's denial of national treatment had a significant adverse effect on U.S. financial firms. Finally, following publication, the secretary was authorized to recommend to federal financial regulators the suspension or denial of authorizations to establish new offices or undertake new activities in banking or securities markets in the United States. The federal regulators were required to act on the recommendation unless they determined that such action would compromise the safety and soundness of the U.S. financial system. In insurance, the President of the United States or a presidential designee exercised similar authority.

Authority to deny or suspend authorizations would have been applied only to prospective applications to commence new operations. Existing operations of foreign financial institutions would not have been affected in order to minimize the potential disruption to the U.S. market. The bill provided ample discretion to both the Executive Branch and to federal regulators to safeguard the safety and soundness of U.S. financial markets and to protect investors.

The bill was carefully crafted to be exercised in a manner consistent with and supportive of the commitments the United States may take in the General Agreement on Trade in Services (GATS). Moreover, the Clinton administration was willing to provide full market access and national treatment to firms from countries that were prepared to commit in the GATS to a specific transitional arrangement for moving toward greater openness and national treatment.

Following the failure of congressional conferees to resolve disagreements between the House and Senate regarding FTFS, House members introduced the National Treatment in Banking Act of 1994, which dealt only with the banking sector. The House passed the bill, but the Senate was unable to act on it during the 103rd Congress.

NATIONAL TREATMENT UNDER U.S. BANKING LAW

There have been a number of legal and regulatory developments since 1990 that affect foreign banks. The most important, discussed in greater detail below, are:

- The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which makes up title II, subtitle A, of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA);

- The Subsidiary Requirement Study, required by the FBSEA;

- The Capital Equivalency Report, also required by the FBSEA;

- The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA); and

- The Interstate Banking and Branching Efficiency Act of 1994.

FDICIA, enacted in large part in response to the period in the late 1980s when a number of U.S. banks failed, provided a means to replenish the Bank Insurance Fund and to improve supervision and examination of all insured depository institutions in the United States. The FBSEA, which is incorporated in FDICIA, amended several existing federal banking laws, notably the International Banking Act of 1978 (IBA), in order to strengthen prudential regulation of the entry and operations of U.S. offices of foreign banks. The Subsidiary Requirement Study and the Capital Equivalency Report, required under the FBSEA, reinforce the U.S. commitment to the principles of national treatment and investor choice. The recently enacted Interstate Banking and Branching Efficiency Act of 1994 is a major statutory advance toward eliminating geographic barriers to nationwide banking in the United States for both domestic and foreign banks. These and other changes discussed below affecting the entry, supervision, and operation of foreign banks in the United States provide national treatment to foreign banks.

Entry and Operation of Foreign Banks in the United States

The United States generally offers investor choice with regard to the form of entry that a foreign financial institution may use to establish a U.S. presence in banking. The dual banking system in the United States provides the opportunity for either a federal or state license.[1] The principal forms of establishment are: a federally or state-chartered commercial bank subsidiary; a federal- or state-licensed branch or agency; a representative office; an Edge Corporation subsidiary chartered under federal law; an Agreement Corporation organized under state law but subject to Federal Reserve regulation; and investment companies organized under New York State law.

Establishment of branches or agencies of foreign banks is prohibited by law in some states of the United States, but those states that are considered important major financial centers permit foreign bank branches and/or agencies — e.g, New York, California, Illinois, Texas, Florida, and Georgia.

Edge Corporations are specialized entities that engage in international or foreign banking and other international business activities. Both domestic and foreign banks are permitted to establish Edge Corporations. These companies enjoy greater authority for geographic expansion than U.S. incorporated commercial banks and are not subject to restrictions on interstate branching (see Interstate Banking and Branching below).

Branches and agencies are the preferred form of establishment by foreign banks; there were 413 and 167, respectively, at the end of June 1994. In addition, there were 91 foreign bank-owned

[1] The Office of the Comptroller of the Currency (OCC) charters national banks and licenses federal branches and agencies.

bank subsidiaries, six investment companies, and 12 Edge Corporations and Agreement Corporations. These numbers have changed little since 1990. These U.S. operations of foreign banks control $872 billion in assets, or 21 percent of the total assets of the U.S. commercial banking system. In addition, there were about 250 representative offices of foreign banks in the U.S.[2]

Foreign banks with U.S. branches or agencies were first subjected to federal regulation with the passage of the International Banking Act of 1978. The IBA, in providing for the first time for federally licensed branches and agencies of foreign banks, required that such branches or agencies generally operate under the same restrictions and conditions applicable to a national bank operating at the same location.[3] The IBA required foreign banks operating offices in the United States to maintain reserves against deposit liabilities and limited their activities and geographic expansion in the United States in accordance with the comparable limitations applicable to U.S. banking organizations.

The IBA did not extend to foreign banks a number of federal requirements imposed on U.S. banks. For example, it did not require prior federal review of foreign bank entry into the U.S. market if the foreign bank sought a state, rather than a federal, license, nor did it provide for a federal role in the termination of a state-licensed branch or agency of a foreign bank. The Congress saw the need for additional federal regulation of foreign banks in the United States largely as a result of concerns raised by the alleged fraudulent or illegal activities of foreign banks such as the Bank of Commerce and Credit International (BCCI) and Banca Nazionale del Lavoro (BNL). As a result, Congress enacted the FBSEA on December 19, 1991.

Foreign Bank Supervision Enhancement Act of 1991

Problems in bank supervision, principally those associated with BCCI and BNL, led to legislation entitled the Foreign Bank Supervision Enhancement Act of 1991, which strengthened the federal regulators' supervisory authority with respect to foreign banks. The FBSEA

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[2] Source: Federal Reserve Board

[3] Pursuant to the IBA, the Office of the Comptroller of the Currency (OCC), the licensor and primary supervisor of federal branches and agencies, requires the parent bank to establish and maintain a *capital equivalency deposit* (CED) with a Federal Reserve member bank. Prudential in nature, the CED is technically a pledge of assets to the OCC calculated as a percentage of third-party liabilities of the branch or agency; the CED provides a cushion of protection for depositors and other creditors. Lending, investment, and other limits for federal branches and agencies are *not* limited by the CED; rather, they are based on the consolidated worldwide parent capital. A few states have explicit *asset pledge requirements*, which are similar to a CED and broadly constitute the amounts the chartering authorities expect all foreign banks to have in the jurisdiction in order to do business. In addition, *asset maintenance requirements* may be imposed by state or federal authorities on a case-by-case basis in circumstances where serious prudential concerns have been identified. The amounts imposed generally represent a specified percentage excess of qualifying assets over third-party liabilities of the branch or agency.

authorized greater federal oversight of foreign banks in order to ensure that multistate U.S. offices of foreign banks were regulated, supervised, and examined within the same broad framework as U.S. banks. FBSEA amended existing U.S. law in several ways, most notably with respect to uniform standards and creating a federal approval requirement for all foreign banks seeking to establish U.S. offices, whether licensed by federal or state authorities.

Establishing offices. Section 202(a) of the FBSEA amended the IBA to require prior FRB approval for the establishment of state-licensed and federally licensed branches and agencies, and representative offices of foreign banks, or to acquire ownership or control of a commercial lending company. This is in addition to the existing licensing approval by the federal regulator — OCC — or state primary regulator, mandated by the IBA. It further provided mandatory and discretionary criteria for FRB approval of applications to establish offices.

Under the statute, the FRB may not approve applications to establish branches or agencies unless it determines, among other things, that: (1) the applicant foreign bank engages directly in banking outside the United States, (2) the applicant foreign bank is subject to comprehensive supervision on a consolidated basis by home country authorities, and (3) the foreign bank has furnished the FRB the information necessary to assess adequately the application. In considering applications for representative offices, the FRB may take into account the same standards applicable to the establishment of branches and agencies and may impose any additional requirements that it determines are necessary. Between the date of enactment on December 19, 1991, and November 1, 1994, the FRB approved 20 applications for new foreign bank offices: three state-licensed and three federally licensed branches, five state-licensed agencies, and nine representative offices of banks from various countries in Europe, Asia, and South America.

The FBSEA requirement that a foreign bank must be subject to comprehensive consolidated supervision (CCS) in order for the FRB to approve the establishment of a branch or agency has slowed the establishment of offices in the United States by foreign banks. Supervision on this basis is not the norm worldwide, although the 1992 "minimum standards" established by the Basle Committee on Bank Supervision lend strong support to the adoption of this approach by the supervisors of internationally active banks. The Federal Reserve has emphasized multilateral and bilateral outreach activities that encourage foreign supervisors to implement a system of CCS, explain what such a system should entail, and provide technical assistance to achieve that end, if requested. The OCC and FDIC also maintain substantial contact with foreign supervisory authorities. In March 1993 the FRB also implemented new procedures to facilitate processing of applications.

Authority to terminate offices. FBSEA also permits the FRB to order a foreign bank that operates a state-licensed branch or agency or commercial lending company subsidiary in the United States to terminate its activities if the FRB finds that the foreign bank is not subject to comprehensive, consolidated supervision by its home country supervisor or it has reasonable

cause to believe that the foreign bank or an affiliate has committed a violation of law or engaged in an unsafe or unsound banking practice in the United States. With respect to federal branches or agencies, the FRB may transmit a recommendation to the Comptroller of the Currency that the license should be terminated. The FRB may also order the termination of the activities of a representative office on the basis of the standards, procedures, and requirements applicable to branches and agencies.

Bank acquisitions. Section 207 of FBSEA made foreign banks maintaining a branch, agency, or commercial lending company in the United States subject to section 3 of the Bank Holding Company (BHC) Act in the same manner and to the same extent as U.S. bank holding companies. Following this change, if a foreign bank maintaining a branch or agency in the United States wishes to acquire more than 5 percent of the voting shares of a U.S. bank or bank holding company, it must file an application with the FRB under the BHC Act. Foreign banks generally must meet the same standards as U.S. banks, including capital position and financial resources, when acquiring bank or nonbank subsidiaries in the United States.

Retail deposits. The Congress effectively precluded all but existing insured branches of foreign banks from engaging in retail deposit-taking activities by requiring, under section 214(a) of the FBSEA, that such activities be conducted through U.S. banking subsidiaries the deposits of which are insured by Federal Deposit Insurance Corporation (FDIC). Specifically, section 214(a) as amended for clarification in 1992, provides that no foreign bank may accept or maintain *retail* deposits of less than $100,000, except through an insured banking subsidiary. Branches that were insured prior to December 19, 1991, are grandfathered.

Subsidiary Requirement Study. Section 215 of the FBSEA required Treasury and the FRB jointly to conduct a study of whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches. This Subsidiary Study was submitted to Congress in 1992. The legislation required the study to take into account a comprehensive set of financial, accounting, legal, regulatory, tax, and competitiveness factors.

The study concluded that "subject to prudential considerations, the guiding policy for foreign bank operations should be the principle of investor choice. The right of a foreign bank to determine whether to establish a branch or a subsidiary is consistent with competitive equality, national treatment and equality of competitive opportunity." The study indicated that, among other things, a subsidiary requirement could have a substantial adverse impact on the ability of U.S. banks to operate through branches overseas by encouraging other countries to introduce such a requirement. The Treasury and the FRB opposed a subsidiary requirement that would be applied to all foreign bank operations in the United States either across-the-board or for purposes of expanded powers.

Capital Equivalency Report. Foreign banks seeking to establish U.S. branches or agencies must demonstrate financial soundness, including capital adequacy that is at least comparable to that

required of U.S. chartered banks. Section 214(b) of FBSEA required the Treasury and the FRB jointly to submit a report analyzing the capital standards contained in the framework for measurement of capital adequacy established by the Basle Committee (the Basle Accord), foreign regulatory capital standards that apply to foreign banks conducting banking operations in the United States, and the relationship of the Basle and foreign standards to risk-based capital and leverage requirements applicable to U.S. banks. The Capital Equivalency Report was submitted to Congress in June 1992, and an update was submitted in August 1994.

In addition, section 214(b) required the FRB, in connection with the Capital Equivalency Report, to establish guidelines for converting data on the capital of foreign banks to the equivalent risk-based capital requirements for U.S. banks for purposes of determining whether a foreign bank's capital level is equivalent to that imposed on U.S. banks. The guidelines set out in the report are to be applied in connection with the FRB's consideration of branch or agency applications under the International Banking Act and applications under sections 3 and 4 of the Bank Holding Company Act.

In the report, the agencies stated that, in assessing the capital of foreign banks in connection with applications, capital ratios should be equivalent, but not necessarily identical, to those required of U.S. banks. The report recognized that financial markets in different countries, and the instruments issued in those markets, vary but that the differences do not necessarily have a substantive effect on overall safety and soundness. The report found that among the countries studied, largely due to these differences in financial markets among countries, some differences have developed with respect to the composition of Tier 2 capital. With regard to the definition and composition of Tier 1 capital, the report found that a high degree of comparability exists among the countries subscribing to the Basle Accord.[4] The subsequent update found no substantive change since publication of the initial report.

Examinations and Federal Reserve examination fees. FBSEA clarifies and strengthens the FRB's authority to make sure that multistate foreign bank operations are examined in a comprehensive and coordinated manner. The FBSEA also requires that each branch and agency of a foreign bank be examined at least once each year. Section 203(a) further authorizes the Federal Reserve Board to examine any office, subsidiary bank, commercial lending company or affiliate of a foreign banking organization, coordinating to the extent possible with the other relevant supervisors.

Section 203(a) also states that the cost of such examinations that the Federal Reserve undertakes shall be assessed against and collected from the foreign bank or its parent holding company. The FRB is not required to impose fees on domestic banks that it examines, although all U.S.

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[4] Under Bank for International Settlements capital adequacy standards, Tier 1 or "core" capital, refers generally to basic equity and disclosed reserves. Tier 2 refers generally to supplementary capital, such as undisclosed reserves, revaluation reserves, and subordinated debt.

banks are assessed to some extent for federal banking supervision. Representatives of foreign banks and governments strenuously opposed the prospective imposition of these examination fees on foreign banks. The recently enacted Interstate Banking and Branching Efficiency Act of 1994 imposes a three-year moratorium on the imposition of Federal Reserve examination fees on the foreign banks that the Federal Reserve examines.

Limitations on powers. The FBSEA prohibits state branches or agencies from engaging in any activity that is impermissible for a federal branch or agency unless the FRB determines that the activity is consistent with sound banking practices, and in the case of an insured branch, the FDIC has determined that the activity would not pose a significant risk to the deposit insurance fund. The effect of this restriction is generally to limit state branches and agencies to those activities in which national banks may engage.

Limits on loans to one borrower. Similarly, under the FBSEA, state branches and agencies are subject to the same loans-to-one-borrower limitations that are applicable to federal branches and agencies, i.e., the limits applicable to national banks.

Reporting of stock loans. Because of the experience with BCCI, in which that institution was found to have acquired illegal control of several U.S. banks through loans to nominees, Congress, in the FBSEA, amended section 7 of the Federal Deposit Insurance (FDI) Act to extend to foreign banks and their affiliates existing requirements that insured depository institutions report to federal banking regulators loans secured by 25 percent or more of an insured institution's voting stock.[5] The FBSEA further expanded the reporting requirements applicable to all covered institutions to include any "credit outstanding" and clarified that loans by one organization to a group of persons acting together to gain control of a U.S. bank must be reported.[6]

Consumer laws. In addition, the FBSEA placed the enforcement of foreign banks' compliance with consumer laws with the appropriate federal banking agencies, thus placing foreign banks in a position comparable to that of domestic banks.

Criteria. Under FBSEA the FRB is required, in consultation with the Secretary of the Treasury, to develop and publish criteria for evaluating the operation of any foreign bank that was established in the United States prior to enactment of FBSEA and that the FRB determines is not subject to comprehensive supervision or regulation on a consolidated basis. These criteria are

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[5] The statute defines "foreign bank" as any foreign bank subject to the provision of the Bank Holding Company Act by virtue of section 8(a) of IBA.

[6] The statute defines "credit outstanding" to include 1) any loan or extension of credit, 2) issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit), and 3) any other type of transaction that extends credit or financing.

for evaluative purposes and will provide a framework for the continued operation in appropriate circumstances of foreign offices established in the United States before FBSEA was enacted, even in the absence of comprehensive consolidated supervision. It is anticipated that the FRB will publish the proposed criteria for public comment before the end of 1994.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 in response to the widespread bank failures of the middle and late 1980s. These failures strained the resources of the existing statutory deposit insurance fund. The primary purposes of FDICIA are to: provide a means to recapitalize the Bank Insurance Fund (BIF), improve supervision and examination of insured depository institutions, require the least-cost resolution of insured depository institutions, and reform both the financial services industry and the federal deposit insurance system. Although title II of FDICIA, FBSEA, was directed specifically at the regulation of foreign banks in the United States, other provisions of FDICIA also affect the supervision of these banks, as well as that of U.S.-owned banking organizations.

Annual audits. FDICIA amended section 36 of the Federal Deposit Insurance (FDI) Act to add new requirements for annual independent audits and reports that apply both to domestic banks and to the insured U.S. branches of foreign banks with assets of more than $150 million. One of these requirements is that each institution have an independent audit committee comprised of outside directors. In its final rule implementing the statute, the FDIC exempted insured (foreign bank) branches from this requirement because such branches do not have a separate board of directors. However, such branches are encouraged to make reasonable good faith efforts to see that similar duties are performed by persons whose qualifications are consistent with requirements of the rule as applicable to the particular branch.

Prompt corrective action. FDICIA added section 38 to the Federal Deposit Insurance Act authorizing or requiring the bank regulatory agencies to take certain supervisory actions when an insured depository institution falls within the lower range of five specifically enumerated capital categories. These categories are, in turn, based on capital maintenance regulations.

Insured branches of foreign banks are required, in lieu of capital, to maintain a pledge of assets and a certain volume of eligible assets, which the FDIC has long maintained is analogous to a domestic bank's required capital.[7] Therefore, for purposes of prompt corrective action, the levels of capitalization for insured foreign bank branches that may trigger supervisory actions are based on the asset pledge and volume of eligible assets.[8] At this time, there are 53 insured

[7] See 12 CFR 346.19-20.

[8] See 12 CFR 325.103(c).

branches of foreign banks in the United States, all of which were established before enactment of FBSEA.

Risk-based assessments. FDICIA also amended section 7 of the Federal Deposit Insurance Act to require the FDIC to establish a system of risk-based deposit insurance assessments. For domestic banks, one of the criteria for determining assessments is the adequacy of capitalization maintained by those banks. Again, because insured branches of foreign banks are required to maintain a pledge of assets and a certain volume of eligible assets in lieu of the capital required for domestic banks, the risk-based assessments for such branches refer to the branches' positions against those requirements.[9]

Crime Control Act of 1990

Section 2597 of the Crime Control Act of 1990 brings branches and agencies of foreign banks and Edge and Agreement Corporations within the scope of the federal criminal code with respect to financial crimes. These crimes include both those committed by banks and their employees and those committed against banks.[10]

Annunzio-Wylie Anti-Money Laundering Act

The Annunzio-Wylie Anti-Money Laundering Act, enacted as title XV of the Housing and Community Development Act of 1992, provides for the termination of the charters/licenses of financial institutions that are convicted of certain money laundering crimes.[11] The provisions

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[9] See 12 CFR 327.3(d).

[10] Section 2597 of the Crime Control Act of 1990 amends the definition of "financial institution" in title 18 of the U.S. Code to include branches and agencies of foreign banks and Edge and Agreement corporations and amends certain sections of title 18 to cover branches, agencies, and Edge and Agreement corporations where they were previously omitted. Among the amended sections dealing with crimes *by* banks or their employees are: section 212 (offer of loan or gratuity to bank examiner); section 656 (theft, embezzlement, or misapplication of bank funds by bank officer or employee); section 1004 (certification of checks before amount has been deposited); section 1005 (making false bank entries, reports and transactions); and section 1906 (unauthorized disclosure of information from a bank examination report). Among the amended sections of title 18 providing foreign bank offices with protection from crimes *against* banks are: section 655 (theft by examiner); section 1014 (making false statements in loan and credit applications); and section 2113 (bank robbery).

[11] Section 1502 of the act requires the Comptroller of the Currency to issue a notice of its intention to terminate the license of a federal branch or agency upon the Comptroller's receipt of written notice from the U.S. Attorney General of the branch's or agency's conviction of a money laundering offense under 18 U.S.C. §§ 1956 or 1957. The OCC retains final discretion over whether or not to terminate the federal branch's or agency's license. For criminal offenses of the currency transaction reporting requirements under 31 U.S.C. § 5322, the Annunzio-Wylie Act gives the OCC discretion in determining whether or not to initiate termination proceedings.

are generally consistent with the treatment accorded under that act to U.S. financial institutions convicted of money laundering crimes.

Government Securities Act Amendments of 1993

The Government Securities Act Amendments of 1993 (GSA Amendments)[12] amended section 3(a)(34)(G) of the Securities Exchange Act of 1934, to clarify that, for purposes of the Exchange Act, the FRB is the "appropriate regulatory agency" for *uninsured* state-licensed branches of a foreign bank that are active as brokers or dealers in U.S. government securities and the FDIC is the appropriate regulatory agency for *insured* state-licensed branches of foreign banks.[13] This authority follows the general division of regulatory responsibility for supervising state-licensed branches of foreign banks. The GSA Amendments also confirmed that the FRB is the appropriate regulatory agency for Edge and Agreement Corporations acting as government securities brokers or dealers.

The GSA Amendments also provided the SEC, the Treasury, and the appropriate federal banking regulatory agencies with expanded authority to monitor the government securities market, detect and prosecute fraudulent or manipulative activities, permit the appropriate regulatory agencies to establish and enforce sales practice regulations in this market, and monitor the public availability of market information.

Interstate Banking and Branching

Many government and financial services industry officials have long argued that one key way to limit the incidence of U.S. bank failures would be to permit greater geographic diversification by banking organizations. Multistate branching and interstate acquisitions by U.S. commercial banks are restricted by the McFadden Act and section 3(d) of the Bank Holding Company Act (the Douglas Amendment). The Interstate Banking and Branching Efficiency Act of 1994, signed by President Clinton on September 29, 1994, authorizes the removal of a number of these barriers to nationwide banking and branching in the United States for both domestic and foreign banks. Implementation of key aspects of the bill is not immediate, but transitional preparations are underway.

Sections 1503 and 1507 of the Annunzio-Wylie Act impose similar requirements on the FDIC, with respect to terminating the deposit insurance of insured state-licensed branches of a foreign bank, and on the Federal Reserve Board, with respect to terminating the activities of state agencies, uninsured state branches, and commercial lending subsidiaries of a foreign bank.

[12] See 15 U.S.C. § 78c(a).

[13] The Board is also the appropriate regulatory agency for state member banks, foreign banks, state-licensed agencies of foreign banks, commercial lending companies owned or controlled by foreign banks.

Currently, a bank holding company (BHC) may establish subsidiary banks in more than one state, to the extent permitted by state laws. Such *interstate banking* has increased markedly in recent years. However, a number of states attach conditions to the entry of a bank that is owned by a bank or BHC headquartered in another state, whether the proposed entry is by establishing a new bank or by acquiring an existing one. Some states may exclude the inward expansion of an out-of-state bank or BHC if its "home" state does not provide reciprocal access for banks or BHCs of the host state, or if the home state is not a member of a "regional compact" of neighboring states that have agreed to allow mutual access. A few states may also exclude expansion by foreign-owned banks into their jurisdictions. The newly enacted banking and branching legislation will prohibit continuation of differential treatment of any out-of-state bank or BHC for the purpose of acquiring a bank subsidiary in another state.

As a general rule, U.S.-incorporated banks may not establish branches outside their home state. Foreign banks have enjoyed a greater degree of flexibility with respect to *interstate branching* than domestic banks. Although the IBA eliminated foreign banks' previous ability to establish branches in more than one state, the legislation allowed existing multistate operations to continue. Foreign banks continued to be able to establish agencies and limited deposit-taking branches in more than one state; these are functionally equivalent means of competition with multistate branches of Edge Corporations that domestic banks may establish. The new interstate legislation will preserve existing foreign bank rights and will authorize interstate branching for foreign and domestic banks to the extent that states choose to permit it.

Riegle/Neal Interstate Banking and Branching Efficiency Act of 1994

The Riegle/Neal Interstate Banking and Branching Efficiency Act of 1994 essentially affords foreign banks national treatment in respect of interstate banking and branching. The administration successfully urged the Congress not to adopt an approach contained in the bill that initially passed the Senate that would have required a foreign bank to own a U.S.-incorporated bank in order to benefit from the interstate branching authority proposed in the bill. In adopting the approach provided in the House of Representative's version of the bill, the Congress assured that foreign banks will be accorded the same interstate branching authority as domestic banks.

The legislation opens three avenues of interstate expansion for foreign and domestic banks:

- interstate banking by multistate acquisition of banks;

- interstate branching by acquiring and consolidating banks or bank branches in more than one state; and

- interstate branching by establishing de novo branches or agencies in more than one state.

Nationwide interstate banking by acquisition. The statute will permit adequately capitalized and managed bank holding companies (a term that includes foreign banks) to acquire a bank in any state *one year after enactment* of the legislation, regardless of existing regional compacts or national reciprocal agreements. States may place minimum age requirements on the banks within their jurisdiction that may be acquired.

The statute also provides a 10 percent cap on the amount of nationwide deposits that an acquirer may control following the interstate acquisition. In addition, there is a 30 percent cap on the amount of deposits in a state an acquirer may control following a second, not an initial, acquisition in that state or in any other state where the acquired institution is present. States also may impose their own limits on the deposit concentration accruing to the acquirer. Concentration limits must be nondiscriminatory; they must apply equally to all out-of-state acquirers.

Interstate branching by merger. Beginning June 1, 1997, the responsible banking regulators may approve a merger transaction between one bank and another, out-of-state bank. The bank would then convert the merged bank's offices into branches. Concentration limits similar to those applicable to interstate banking acquisitions also apply to interstate branching by merger, except for mergers involving only affiliated banks.

States may enact laws before June 1, 1997, that opt out of interstate branching by merger, however. A bank from a state that opts out may not participate in interstate branching by merger. States may also pass laws to opt in early. These early opt-in state laws may apply nondiscriminatory conditions to interstate branching by merger, so long as the conditions are not preempted by federal law and do not apply or require performance after May 31, 1997.

Interstate branching by de novo establishment of direct branches. A bank will be able to establish and operate a de novo branch in a state in which the bank does not already operate so long as the host state *opts in* by *expressly permitting* in state law de novo interstate branching Opt-in laws must apply equally to all banks. There is no time limit for opting in.

National treatment will be afforded to foreign banks in relation to the following interstate authority:

- Opportunities for interstate banking, whether in terms of acquisition of a U.S. bank located in a state other than the home state of the bank holding company or the merger of U.S. banks having different home states, are available to foreign banks (including those having only bank branches, rather than bank subsidiaries, in the United States) to the same extent as to U.S. bank holding companies.

- A foreign bank in general may establish and operate a federal or state branch or agency in any state outside its home state to the same extent as a domestic bank with the same home state.

- A U.S. bank controlled by a foreign bank may establish branches outside its home state to the same extent as other U.S. banks.

To address perceived competitive advantages of wholesale direct branches of foreign banks compared to domestic banks, Congress introduced four specific foreign bank provisions (section 107). In addition, the legislation amends the provision of the FBSEA dealing with fees for Federal Reserve examinations of foreign banks (section 115), and includes a community credit provision applicable to foreign and domestic banks (section 109). These provisions of the interstate banking and branching legislation do not deviate from the principle of according national treatment to foreign banks.

Meeting community credit needs (section 107). If a foreign bank acquires an existing bank or branch in a state in which the foreign bank does not maintain a branch, the Community Reinvestment Act (CRA) shall continue to apply to each branch of the foreign bank that results from the acquisition. The CRA requirement shall not apply to any branch that receives only such deposits as are permissible for an Edge Corporation.

The foreign bank CRA requirement was narrowly drafted to apply only in the case of an initial interstate entry by a foreign bank through the *acquisition* of an existing entity that, prior to acquisition, was subject to CRA. The provision explicitly provides that the CRA requirement will not apply if the branch takes only those deposits that are permissible for an Edge Corporation (e.g., deposits from foreign governments, foreign persons, foreign banks, and International Banking Facilities and nonretail deposits related to international or foreign business). U.S. banks will also acquire banks or branches subject to CRA, but the Edge type deposit alternative is not a realistic option for a U.S.-incorporated bank. The U.S. bank would have to relinquish its bank charter in order to avoid the CRA.

Concerns have been raised that this provision may be inconsistent with national treatment. Upon making an initial interstate entry by acquisition of a U.S. financial institution subject to CRA, a foreign bank not previously insured by the FDIC or subject to CRA, and engaged principally in wholesale banking, will be subject to CRA, even though it will not be able to take insured "retail" deposits (section 214(a) of the FBSEA permits only subsidiaries and grandfathered insured branches, not new direct branches, to take retail deposits in the United States). No CRA requirement was imposed on all foreign bank branches. The provision treats foreign banks that choose to make such interstate acquisitions like similarly situated U.S.-incorporated banks such as those primarily engaged in wholesale operations or credit card banks that do not take retail deposits, but are nonetheless subject to CRA requirements.

Review of regulations on deposit taking (section 107). The FDIC and the OCC must review their regulations that permit uninsured branches of foreign banks to accept certain initial deposits of under $100,000. Regulators will review the permissible sources of such deposits that are excepted from the definition of "retail" deposits requiring deposit insurance. If warranted, the

FDIC and the OCC may revise the regulations to ensure that foreign banks do not receive a competitive advantage compared to U.S. banking organizations in accepting these small, uninsured deposits. The bill also requires that the de minimis exception, allowing a foreign bank branch to accept initial deposits of under $100,000, up to 5 percent of the average deposits of the branch, be reduced to 1 percent, notwithstanding the outcome of the regulatory review of specific source-based exemptions described above.

Management of shell branches (section 107). The IBA is amended to provide that a U.S. branch or agency of a foreign bank may not, through an offshore shell branch that it manages or controls, manage types of activities that a U.S. bank is not permitted to manage at a foreign branch or subsidiary. The provision was included in order to avoid any potential for a foreign bank to use its U.S. branches or agencies to manage types of activities through offshore shell branches that U.S. banks could not manage. Generally speaking, a "shell" branch is an entity having no personnel or operations in the jurisdiction where it is established and authorized to do business. The restrictions would not apply to foreign bank's non-U.S. offices that are not "managed or controlled" from a U.S. office.

Consumer protection laws (section 107). The IBA is amended to affirm that direct branches and agencies of foreign banks and commercial lending companies are subject to consumer protection laws. This provision reaffirms existing law and practice.

Examination fees (section 115). The FBSEA is amended to provide a three-year moratorium on the imposition of Federal Reserve examination fees on foreign banks pursuant to section 203 of the Foreign Bank Supervision Enhancement Act of 1991.

Deposit production offices (section 109). This provision is intended to ensure that interstate branches of foreign and domestic banks are reasonably helping to meet the credit needs of the communities that the branches serve. It requires federal banking agencies to prescribe uniform regulations by June 1, 1997, that will prohibit an out-of-state bank from using interstate branching primarily for the purpose of raising deposits for lending outside the host state. Failure to comply could be grounds for closing the branch. Concerns have been raised that the quantitative standards for comparing the performance of out-of-state banks with those of existing in-state banks may affect foreign banks disproportionately.

Foreign bank branches operate principally in a wholesale banking capacity, raise funds from the parent and in international, interbank and wholesale markets, and would not necessarily be seeking to meet the retail credit needs of a local community to the same extent as a local bank. Furthermore, except for grandfathered insured branches, direct foreign bank branches may not accept retail deposits. Foreign bank representatives have expressed concern that the local credit performance of their interstate branches may not be fairly linked to their local deposit raising activity. There will be ample opportunity for consideration of proposed federal regulations when they are published for public comment.

Nonbanking Activities of Foreign Banks

Foreign banks that engage in commercial banking in the United States, whether through branches, agencies, commercial lending company subsidiaries or bank subsidiaries, are subject to the provisions of the Bank Holding Company Act of 1956 (BHC Act). The BHC Act provides that a bank holding company or foreign bank may engage in the United States only in banking activities or *activities closely related to banking*. Under this standard, a foreign bank may engage in a wide range of financial activities in the United States, such as consumer and commercial lending, trust activities, leasing, data processing, investment advisory and private placement services, foreign exchange activities and operating thrift institutions. Foreign banks may also engage in securities underwriting and dealing activities through subsidiaries, which are described further in the next section.

Although the BHC Act generally prohibits bank holding companies from engaging in nonfinancial activities, there are two exceptions that are made for foreign banks. First, foreign banks that became subject to the International Banking Act of 1978 were grandfathered to retain any nonbanking activities in which they were engaged at that time; 17 foreign banks were grandfathered to operate securities affiliates, even though no similar grandfathering was provided to U.S. bank holding companies. Three of these 17 foreign banks have subsequently relinquished their grandfather rights, two in connection with an acquisition of a U.S. bank subsidiary and one through the merging of its grandfathered securities company with its Section 20 subsidiary (see discussion below).

Second, in order to prevent disruptions in the relationships between foreign banks and their commercial and industrial affiliates, these affiliates are allowed to engage in the United States in the same nonfinancial activities that they conduct abroad. A foreign affiliate is not allowed to conduct financial activities in the United States except on the same basis as an affiliate of a U.S. bank holding company.

Securities Activities of Banking Organizations in the United States

The Glass-Steagall Act, enacted in 1933, established a separation between commercial and investment banking in the United States. Under this law and Federal Reserve and OCC regulation, banks are generally prohibited from underwriting or dealing in securities of nongovernmental issuers. The IBA extends this restriction to the U.S. branches and agencies of foreign banks.

Although banks in the United States are generally prohibited from underwriting or dealing in securities of corporate issuers, subsidiaries of bank holding companies may engage in such activities, and banks may engage in many other securities activities. A foreign bank is in the same general position as a U.S. bank or bank holding company with respect to its ability to conduct securities activities in the United States and is thus accorded national treatment. U.S.

banks and bank holding companies may underwrite and deal in government securities, and they may engage directly or indirectly in the brokerage of all types of securities.

U.S. banks and subsidiaries of bank holding companies may also act as agent in the private placement of all types of securities. This activity, which is not considered underwriting because it is not offered on public markets, must be conducted within the limits of U.S. securities law and within certain prudential limits that generally prohibit an affiliated bank from purchasing for its own account or providing a credit enhancement for any security privately placed by a securities affiliate. The FRB has approved numerous foreign banks to engage in this activity.

Section 20 Approvals

In January 1989, under the Federal Reserve Board's interpretation of Section 20 of the Glass-Steagall Act, the FRB approved applications by five U.S. bank holding companies to underwrite and deal in *all* types of debt and equity securities subject to revenue limitations and certain additional prudential restrictions or conditions. These conditions, or "firewalls," are designed to (1) insulate the U.S. bank from risks in the securities affiliate, (2) limit the transfer of risk to the U.S. federal safety net, (3) prevent conflicts of interest, and (4) preserve competitive equality with securities companies not affiliated with banks.

The firewalls prohibit affiliated banks from providing credit to or for the benefit of the securities affiliate; prevent sharing of directors, officers, or employees, or of customer information; and require deduction of the securities affiliate's capital from the bank holding company's capital in computing capital requirements.

Certain conditions the FRB applied to domestic bank holding companies were adjusted to account for the status of the foreign banks and to minimize any extraterritorial impact of the framework's requirements. These adjustments included that the foreign bank meet the risk-based capital adequacy standards of its *home country* supervisor consistent with internationally accepted standards under the Basle Accord: the foreign bank's U.S. banks, thrifts, branches and agencies would generally be subject to the same requirements as U.S.-owned banks, except that an interlock is permitted between a U.S. securities subsidiary (interlocks are not permitted for U.S. banks), the foreign bank's non-U.S. operations would be treated in the same manner as those of a U.S. bank holding company, and the responsibility for compliance with the conditions of the FRB's decisions is placed on the U.S. securities company, to avoid interference in the non-U.S. operations of the parent foreign bank.

As of September 30, 1994, the FRB had approved 33 companies to engage in underwriting and dealing in debt securities. Of these, 11 were owned by foreign banks.

Primary Dealers

The core participants in the United States government securities market are 39 primary dealers (compared with 41 in 1990), nearly half of which are foreign-owned. A primary dealer is a firm that has established a trading relationship with the Federal Reserve Bank of New York (FRBNY). Some primary dealers are banks or bank subsidiaries, some are departments of general securities broker-dealers (including subsidiaries of bank holding companies) and others are firms specializing in government securities and other money market instruments.

Firms designated "primary" dealers by the Federal Reserve voluntarily report weekly to FRBNY on their volume of trading and their positions (holdings) in government and government agency issues. They also provide weekly reports on financing and periodic reports on their financial condition.

In order to be added to the list of primary dealers, a firm is expected to: (1) make markets in the full range of Treasury issues for a reasonably diverse group of customers, (2) participate meaningfully in Treasury auctions, (3) be committed to continuing as a market-maker in these securities over the long term, (4) have management depth and experience and good internal controls, and (5) have sufficient capital to support its activities and prudently manage its risk exposure. Minimum absolute levels of capital are specified ($100 million for commercial banks and $50 million for broker/dealers) to help ensure that primary dealers are able to enter into transactions with the Federal Reserve in sufficient size to maintain the efficiency of open market operations.

In its relations with primary dealers, the FRBNY accords foreign-owned dealers essentially the same treatment as domestically owned dealers, subject to the constraints of the Primary Dealers Act of 1988. That act, which took effect on August 23, 1989, requires the Federal Reserve to determine whether U.S. firms operating in the government debt markets of certain foreign countries have "the same competitive opportunities" as domestic companies operating in those markets. If a country does not offer "the same competitive opportunities" to U.S. firms, a person (including a company) from that country may not control a primary dealer in the United States. The Federal Reserve "may not designate or permit the continuation of any prior designation" of a firm from that country as a primary dealer.

Pursuant to the act, the Federal Reserve conducted extensive studies of the government debt markets in the United Kingdom, Japan, Switzerland, Germany and France. It determined that U.S. firms are accorded "the same competitive opportunities" as domestic firms in those countries. The act excludes from its coverage firms from a country with which the United States has a trade agreement or was as of January 1, 1987, negotiating to enter into a trade agreement with the United States, and firms that had been designated as primary dealers prior to July 31, 1987. As a result of these provisions, several firms either were exempt from the act or were grandfathered. As of June 23, 1994, 19 primary dealers were owned by foreign firms from

seven countries, compared with 15 foreign-controlled primary dealers from five countries in 1990.

Futures, Options, Other Derivatives and Commodities Activities

Registration. Transactions in futures and commodity options, including options on futures and on certain commodities including foreign currencies, conducted on domestic futures exchanges are governed by the Commodity Exchange Act (CEA). Any bank or bank holding company acting in the futures or commodity options markets solely for proprietary purposes is deemed to be a trader under rules and regulations of the Commodity Futures Trading Commission (CFTC) and thus is subject to all CFTC regulatory requirements applicable to traders, including large trader reporting of futures and options positions. These requirements apply irrespective of the trader's location in the United States or abroad.

Any bank or bank holding company acting in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading adviser (CTA), or commodity pool operator (CPO) must register in the appropriate capacity with the CFTC.[14] Banks and bank holding companies have performed brokerage (FCM or IB) and investment advisory (CTA) services and have acted as fiduciaries for pooled investment funds (CPO) in connection with a variety of futures and options contracts. Both foreign and domestic banks are subject to the same regulations with respect to their futures and commodity-option activities; foreign-owned banks in the United States and foreign bank holding companies are treated the same as U.S. banks and bank holding companies.

Under the CEA, whether or not a person is required to register with the CFTC is generally a function of that person's contacts with U.S. markets and/or its customers resident in the United States. The CFTC has not required persons located outside the United States who provide

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[14] An FCM is defined as any person who solicits or accepts orders to buy or sell futures or option contracts, and who, in connection with an order, accepts any money or other property (or extends credit) to margin, guarantee, or secure the contracts resulting from the order.

An IB is any person who solicits or accepts orders to buy or sell futures or option contracts, but who does not accept any money or property (or extend credit) to margin, guarantee, or secure the contracts.

A CTA is any person who, for compensation or profit, is engaged in the business of providing commodity interest advisory services to others. The CEA specifically excludes from the definition of the term "commodity trading advisor" certain persons, including banks and news reporters, publishers, and editors, who provide commodity advice that is "solely incidental" to the conduct of their business or profession.

A CPO is any person who solicits funds from others for the purpose of pooling the funds for use in investing in commodity interests. Certain "otherwise regulated" persons and entities such as a bank, an insurance company, or an investment company may be excluded from the term "commodity pool operator" with respect to their operation of "qualifying entities."

commodity-related brokerage and advisory services to non-U.S. persons regarding instruments traded on a U.S. futures exchange to register with the CFTC. The CFTC also has not required non-U.S. persons who only carry a U.S. FCM's customer omnibus account for execution of transactions on foreign exchanges to register with the CFTC.[15]

Foreign banks that are permitted to act directly in a brokerage capacity in their home jurisdictions are not considered to be "located outside the United States" for purposes of relief from registration *if* such banks maintain branches in the United States that act solely in a banking capacity. However, the CFTC has exempted certain banks in Japan, the United Kingdom, and Switzerland from the registration requirements based on, among other things, representations and undertakings from the foreign banks that their U.S. banking branches will not engage in any activity subject to regulation under the CEA (except for proprietary purposes) and that they will provide the CFTC with access to the books and records of the U.S. bank branches to ensure compliance with such representations and undertakings.

There are numerous examples of the differential treatment accorded banks, both U.S. and foreign, under the CEA. For example, in an attempt to avoid duplicative regulation, the CFTC has taken cognizance of the "otherwise regulated status of banks." Banks generally are excluded from the definition of "commodity pool operator" pursuant to CFTC rule 4.5 with respect to their operation of certain "qualifying entities," for example. Although the operator of the qualifying entities are still subject to CFTC jurisdiction, they are relieved from many of the requirements applicable to CPOs in light of their regulation by bank supervisory agencies.

In addition, the CFTC has recently granted relief from the registration requirement to a foreign bank that proposed to act as an offshore introducing broker (i.e., introducing accounts of non-U.S. persons for trading on U.S. contract markets on a fully disclosed basis to registered FCMs in the United States). The non-U.S. customers also would maintain normal banking relationships with the foreign bank. But for the foreign banks' offices and branches, registration would not have been required.[16] The CFTC has also granted relief to a similarly situated foreign bank that sought to act as both an FCM in introducing its non-U.S. customers' omnibus accounts to

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[15] A U.S. FCM with customers that want to trade on a foreign exchange where the U.S. FCM is not a clearing member must establish a customer omnibus account with a clearing member of such foreign exchange to execute the transactions. All funds of such customers will be channelled into the omnibus account maintained by the U.S. FCM for transactions on behalf of its U.S. customers.

[16] Relief from registration was granted on condition that, among other things, none of the U.S. offices and branches would engage in any activities subject to CFTC regulation (other than proprietary trading), the U.S. branches would provide access to their books and records, and the bank would require that the U.S. FCMs obtain an acknowledgement from their non-U.S. customers introduced by the foreign bank that the financial protections of U.S. regulation do not extend to funds, securities, or property transmitted by the FCM to a third party who is not a CFTC registrant.

a U.S. FCM and as an IB in introducing accounts of non-U.S. customers on a fully disclosed basis to a U.S. firm.

In March 1993, the CFTC granted registration relief to a foreign firm that was exempted under rule 30.10.[17] The particular foreign firm proposed to introduce to a U.S. FCM orders of certain U.K. branch offices of U.S. corporations, including banks, for transactions on U.S. contracts markets. Under existing standards, a firm accepting orders for U.S. contracts from such U.S. customers ordinarily would be required to register with the CFTC. Nonetheless, relief was granted in part based on the status of the customer (i.e., highly qualified institution, operating as an independent profit center outside the United States), the rule 30.10 status of the firm (i.e., otherwise regulated), and the fact that the accounts of each customer would be carried by a U.S. FCM on a fully disclosed basis. Relief was subsequently made available to any similarly situated firm operating with confirmed rule 30.10 relief, provided such action by the rule 30.10 firm would be otherwise consistent with the laws, rules, and regulations in effect in the home jurisdiction.

Transactions by banking organizations. Under the CEA, a foreign bank doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic bank. Under relevant federal and state banking laws, foreign and domestic banks operating in the United States are subject to certain restrictions upon the scope of their activities related to commodity futures and options. These restrictions generally are designed to limit bank activities to banking-related functions and to protect the financial soundness of banks and the banking system. In substantially similar guidelines relating to certain derivatives activities of the banks subject to their oversight, the OCC and the FRB stress that banks' use of the specified derivatives contracts must be in accordance with "safe and sound banking practices and with levels of activity reasonably related to the bank's business needs and capacity to fulfill [its] obligations under the contracts."

Under the Bank Holding Company Act and Federal Reserve Regulation Y, bank holding companies are expressly authorized to act, by means of a subsidiary, as FCMs and CTAs for a customer with respect to a variety of commodity futures and option contracts in financial instruments. These include bullion, foreign exchange, government securities, stock, and certain money market instruments.[18] These types of activities are characterized as so closely related to banking as to be a proper "incident" thereto. Bank holding company FCMs that engage in

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[17] Under the CFTC's rule 30.10, persons located outside the United States who solicit or accept orders and related funds from U.S. customers for *foreign* futures or options transactions, and who are subject to a *comparable regulatory scheme* in the jurisdiction in which they are situated, may apply for an exemption from the application of certain of the Part 30 rules applicable to such transactions.

[18] See 12 CFR §225.25(b)(18) (1993).

clearing activities may not trade for their own account other than for hedging purposes.[19] On a case-by-case basis, bank holding companies may also seek to engage in conduct not specified in Regulation Y. The FRB has approved, among other things, transactions involving stock index and municipal bond futures as permissible activities for operating subsidiaries of bank holding companies.

The FRB has recently modified and, in certain cases, eliminated the prior approval requirements for bank holding companies that seek to act as an FCM for additional financial instruments or to act as an FCM on additional commodities exchanges, where the bank holding company already has approval to engage generally in FCM activities. The FRB has recently approved under the Bank Holding Company Act an application of a foreign bank to provide, through its wholly-owned subsidiary, FCM execution and clearance services to institutional customers with respect to certain agricultural and energy futures and options contracts.[20]

The OCC has concluded that national banks and their subsidiaries may enter into derivative transactions for their *own account* where the bank may lawfully trade, deal in or purchase the underlying instrument or product for its own account. The OCC has imposed prudential and supervisory conditions governing the manner in which these activities are conducted.[21] The OCC has recognized that a national bank may enter into derivative transactions for its own account to hedge risk exposure, to engage in arbitrage activities, and as part of the bank's dealer-bank trading activities. In connection with a bank subsidiary's derivatives activities, the OCC has also approved exchange membership, floor trading, and market making activities.

National banks may also enter into derivative transactions as *agent* for their customers. The OCC has recognized that the purchase and sale of derivative instruments as agent for customers are part of the business of banking and thus within the powers of national banks and their

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[19] See 12 CFR §225.25(b)(18) (1993).

[20] See Bank of Montreal Order Approving Application to Engage in Futures Commission Merchant Activities (September 28, 1993).

[21] OCC Banking Circular 277 provides guidance on risk management practices for national banks and federal branches and agencies engaging in financial derivatives activities, including participation as an end-user or as a financial intermediary. It specifically addresses credit, market, liquidity, operations, and legal risk management systems. Circular 277 provides that a bank should have comprehensive written policies and procedures to govern its use of financial derivatives and that senior management should establish an independent unit or individual responsible for measuring and reporting risk exposure.

operating subsidiaries.[22] This authority exists regardless of the underlying commodity upon which the futures (or other derivative instruments) are based, because the futures or option (or other derivative instrument) itself is a financial instrument. Accordingly, the OCC has permitted operating subsidiaries of national banks to register as FCMs and to *solicit, accept, and execute customer orders* for futures, options, options on futures and other exchange-traded and over-the-counter instruments as an incident to the business of banking. The OCC has also approved the expansion of a national bank operating subsidiary's FCM activities to include the provision of execution, clearing, and advisory services for customer transactions in both financial and nonfinancial futures and options and to become members of exchanges and clearing associations affiliated with such exchanges.[23]

A national bank may also enter into derivatives transactions as *principal* where the bank is serving as a financial intermediary for its customers, whether or not the bank has the power to act as principal for its own account with respect to the underlying instrument or product. For example, the OCC has permitted national banks to enter into matched and unmatched commodity price index swap transactions in order to assist their customers that desire to limit certain financial risks resulting from variations in commodity prices, and to hedge such transactions on a portfolio basis. Just as with its deposit and lending activities, in matched and unmatched swap transactions a bank acts as a financial intermediary on behalf of its customers, making and receiving payments.

National banks can generally hedge the market risk associated with such commodity-based derivatives activities by entering into exchange-traded and over-the-counter cash-settled transactions, such as exchange-traded futures and options contracts and over-the-counter spot, forward, and option contracts. In some instances, however, both exchange-traded and over-the-counter transactions that are cash-settled may provide less than completely accurate hedges. Accordingly, the OCC has recently concluded that it is legally permissible for a national bank to engage in *physical commodity transactions* in order to manage the risks arising out of commodity derivatives transactions. Given the potential additional risks associated with physical hedging activities, however, a national bank may not engage in such activities unless it has submitted a detailed plan for such activities to the OCC, and the plan has been approved in writing by the OCC's supervisory staff.

State member banks are chartered under state law, and must have authority under state law to engage in derivatives transactions. In some states, state member banks have been permitted to use exchange-traded interest rate and foreign exchange derivatives to hedge interest rate and

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[22] See 12 U.S.C. § 24(Seventh).

[23] With respect to customer accounts, national banks and their subsidiaries are authorized to execute transactions in options and futures contracts provided that the bank is authorized to execute transactions for the account of customers in the underlying financial product or instrument.

foreign exchange exposure.[24] In at least one state, banks are permitted to act as FCMs, engaging in trading for customers and for their own account in exchange-traded interest rate and foreign exchange derivatives. This activity generally takes place in a subsidiary.

A small number of state-chartered banks that are members of the Federal Reserve System ("member banks") engage in derivative transactions linked to equities or commodities other than interest rates or foreign currencies. Some of these transactions are related to traditional bank activities in commodities such as gold and silver, but some state member banks have obtained approval from their state regulatory authorities for activities involving a wider range of commodity-linked and equity-linked transactions. State member banks have been permitted by some state regulatory authorities to engage as a principal in over-the-counter (OTC) derivative transactions linked to commodities or equities and to use exchange-traded derivatives to hedge exposure created by OTC transactions.

The FRB has required state member banks engaging as principal in derivatives transactions linked to commodities or securities that the state member bank is not authorized to purchase and hold directly (other than transactions entered into on a perfectly matched basis) to obtain the approval of the FRB to continue such activities. State member banks that currently are not engaged in such transactions will be required to seek FRB approval to commence such activities in the future.[25] The FRB recently issued a new guidance letter that provides examiners guidance for evaluating the risk management and internal controls of bank trading activities, including participation as end-users.[26]

Banks are major participants — both as end-users and as financial intermediaries — in the large and developing swap transactions market. The CFTC has recently issued a rule pertaining to swaps transactions that provides greater legal certainty for the swaps market than the CFTC's earlier swaps policy statement. Swaps transactions that comply with the criteria of the rule are not subject to regulation under the CEA, but they may be subject to the anti-fraud provisions of the act.

The marketing of "hybrid" instruments that couple elements of futures contracts with certain banking instruments such as depository obligations has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC regulations. The CFTC recently issued a rule amending its hybrid instrument exemption. The new rule applies to certain hybrid instruments that combine characteristics of commodity futures contracts or commodity options

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[24] E.g., California and New York.

[25] The FRB is continuing to review the applications of state member banks currently engaged in such activities which seek to continue engaging in derivatives transactions.

[26] See SR 93-69 (FIS) (December 20, 1993).

with equity, debt, or depository instruments. The rule should eliminate much of the uncertainty surrounding the legal status of these hybrid offerings. Under the new rule, hybrid instruments that are predominantly securities, debt, or depositary instruments would be exempt from CFTC regulation in deference to the primary regulator (see discussion below).

Insurance Activities of Banking Organizations

Banks and bank holding companies are generally not permitted to sell and underwrite insurance except in limited circumstances. National banks may act as insurance agents in towns with a population of less than 5,000, even if the principal office of the bank is located in a community with a larger population. National banks also are permitted to act as brokers to sell variable rate as well as fixed-rate annuities, which the OCC regards as financial investments rather than insurance. However, the legality of national bank sales of annuities and insurance is being litigated in pending court cases under the McCarran-Ferguson Act, as is the authority of state law to restrict or prohibit otherwise legitimate insurance activities.

Bank holding companies are more restricted in their insurance activities. A bank holding company may underwrite and sell credit life, accident, and health insurance related to extensions of credit by the bank holding company or any of its subsidiaries. Nonbank subsidiaries of foreign banks may engage in the same activity.

State law governs the operation of state-chartered banks and state-licensed branches and agencies. A number of states allow banks to act as insurance agents, but other states severely restrict that activity.

Reinsurance letters of credit. The Treasury Department encouraged the National Association of Insurance Commissioners (NAIC) to adopt its model law on Credit for Reinsurance and to provide national treatment to foreign banks. The model law recognized the acceptability of standby letters of credit issued by or confirmed by U.S. branches and agencies of foreign banks meeting certain specified financial standards.

In 1990, the NAIC model was made one of the original laws required by the NAIC for accreditation under the NAIC's Financial Regulation Standards and Accreditation Program. That program establishes baseline solvency regulation standards for the states and a program of certification to encourage compliance with those standards. Thirty-seven states and the District of Columbia are currently accredited by the NAIC, signifying that at least that many jurisdictions, and perhaps more, have adopted the NAIC's model law.

NATIONAL TREATMENT UNDER U.S. SECURITIES LAWS

The federal securities laws generally provide national treatment to foreign brokers, dealers and investment advisers. In addition, foreign issuers are generally subject to substantially the same registration and reporting requirements as U.S. issuers. In recent years, the Securities and Exchange Commission (SEC) has taken various actions aimed at simplifying access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors.

Brokers and Dealers

The Securities Exchange Act of 1934 (Exchange Act) gives the SEC broad regulatory authority over the U.S. securities markets and persons in the securities business. Under the Exchange Act, the SEC supervises the activities of broker-dealers, the national securities exchanges, clearing organizations, and the over-the-counter market.

A broker-dealer, other than a U.S. bank, that uses the U.S. mails, or any other means of interstate commerce, to effect transactions in securities generally must register with the SEC. In registering, a broker-dealer is *not* required to report to the SEC the extent to which it is owned by foreign persons, although it must disclose the identities of certain control persons, whether domestic or foreign.

The SEC's policy with respect to broker-dealers is one of equal market access: the SEC seeks to apply the same requirements to all broker-dealers, whether U.S.- or foreign-owned or U.S.- or foreign-resident. These requirements include filing a registration form with the SEC, satisfying standards of financial responsibility, operational capacity, and integrity, maintaining minimum net capital, and filing reports with the SEC. To ensure that it can enforce the securities laws against a nonresident foreign broker-dealer, the SEC requires such a broker-dealer to appoint the SEC as agent for service of process for securities law related to claims arising out of the conduct of its business as a registered broker-dealer in the United States.

Exchange Act Rule 15a-6 exempts from registration foreign broker-dealers that engage from offshore in certain activities involving U.S. institutional investors and U.S. securities markets. These activities include "nondirect" contacts by foreign broker-dealers with U.S. investors and markets, through execution of unsolicited securities transactions and provision of research to certain U.S. institutional investors. The exempted activities also include: certain "direct" contacts, involving the execution of transactions through a registered broker-dealer intermediary with or for certain U.S. institutional investors, and without such an intermediary with or for registered broker-dealers; banks acting in a broker or dealer capacity; certain international organizations; foreign persons temporarily present in the United States; U.S. citizens resident abroad; and foreign branches and agencies of U.S. persons.

Registered broker-dealers are required to join one or more securities self-regulatory organizations (SROs), such as the national securities exchanges and the National Association of Securities Dealers, Inc. (NASD). In general, SROs are statutorily authorized and are subject to SEC oversight. An SRO is responsible for compliance by its members with rules of the SRO as well as with the Federal securities laws. The Exchange Act specifically limits the ability of the national securities exchanges and the NASD to exclude registered broker-dealers from membership, ensuring that foreign ownership is not a ground for denial of membership. Foreign incorporation, or other organization, of the foreign-owned broker-dealer is not a bar to membership in the NASD and most regional exchanges, but it is a bar to membership in the New York and American Stock Exchanges. These two exchanges permit foreign-owned members, but they require those members to be organized in the United States.

Brokers and dealers whose business is solely in U.S. government securities have been, since 1987, required to register and to meet standards established by the Secretary of the Treasury concerning capital adequacy, protection of customer securities and balances, and record-keeping and auditing. The Government Securities Act of 1986, as amended in 1993, generally does not distinguish between foreign and domestic government securities brokers and dealers. Essentially, government securities brokers and dealers are required to register with the SEC and to become members of an SRO, unless the entity is already registered with the SEC as a broker or dealer or is a financial institution. Government securities brokers or dealers that are already registered with the SEC or that are financial institutions must notify the appropriate regulatory agency of their status as government securities brokers or dealers. The Department of the Treasury has provided an exemption from registration, which parallels SEC Rules 15a-6, for foreign entities that are government securities brokers or dealers.

Investment Advisers

The Investment Advisers Act of 1940 (IAA) establishes a national treatment standard, treating foreign investment advisers substantially the same as domestic advisers. Under the IAA, an investment adviser is defined as one who, for compensation, "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ."

Whether domestic or foreign, investment advisers that use the United States mails or any means or instrumentality of interstate commerce in connection with their business are required to register with the SEC, unless an exemption is available. No particular qualifications are required for registration. Registered advisers are subject to antifraud provisions (as are unregistered advisers), limitations on advisory compensation, and disclosure and recordkeeping requirements.

The following institutions and professionals are excluded from the definition of investment adviser: United States, but not foreign, banks and bank holding companies; lawyers, accountants, engineers, or teachers whose investment advice is solely incidental to the practice of their professions. Also excluded are: brokers or dealers whose investment advice is solely incidental to the conduct of their business as brokers or dealers and who receive no special compensation for such advice; publishers of any bona fide newspaper or financial publication of general and regular circulation; and persons giving advice only with respect to U.S. government securities.

In addition, certain types of investment advisers are exempt from the registration requirements of the IAA. These are: any adviser whose clients are all in the state in which the adviser conducts business and who does not advise with respect to securities listed, or with respect to securities having unlisted trading privileges, on a national securities exchange; any adviser whose only clients are insurance companies; and any adviser with fewer than 15 clients who does not holds himself or herself out to the public as an investment adviser and does not advise registered investment companies.

As noted above, the IAA excludes United States banks and bank holding companies from the definition of investment adviser, but does not exclude foreign banks and bank holding companies. The SEC also requires a foreign investment adviser, as a prerequisite to registration, to appoint the SEC as agent for service of process for securities law claims arising out of the conduct of its business as a registered investment adviser.

Prior to 1992, the SEC staff generally took the position that, once registered, domestic and foreign advisers were subject to all of the substantive provisions of the IAA with respect to both their United States clients and non-U.S. clients. Thus, if a foreign adviser registered to advise U.S. clients, the IAA also would apply to its relationship with clients in its own country. The IAA restricts or prohibits some conduct (e.g., performance-based fees) that may be legal in other countries. As a result, some foreign advisers registered in the United States were not able to engage in certain advisory conduct that was legal in their own countries.

Many foreign advisers avoided this result by registering a separate and independent subsidiary to provide advice to their United States clients, while the foreign adviser-parent would remain unregistered and would be able to advise non-U.S. clients in its home country without being subject to the IAA. To establish that the foreign parent and the subsidiary were, in fact, separate, and that the parent was not doing indirectly what it could not do directly, the SEC staff imposed a number of conditions, such as prohibiting the parent and the subsidiary from sharing personnel and investment advice. These conditions made it difficult for the United States-registered subsidiaries to advise United States clients effectively.

Based on a recommendation in its report, *Protecting Investors: A Half Century of Investment Company Regulation*, May 1992, the SEC staff has determined that the substantive provisions

of the IAA generally should not govern a foreign investment adviser's relationships with its non-U.S. clients unless those relationships involve "conduct" or have "effects" in the United States. Foreign advisers must comply with certain recordkeeping requirements with respect to their non-U.S. clients, and also generally must provide the SEC access to their books and records, and personnel.

The SEC staff has issued several no-action letters that apply this approach. These no-action letters also ease the conditions under which a foreign adviser can register a United States advisory subsidiary, and thus provide advice to United States clients, without requiring the parent itself to register under the IAA. Most importantly, the letters permit the foreign adviser and the United States subsidiary to share personnel and investment advice as long as the SEC has access to trading and other records of each affiliate involved in the United States advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States clients or markets. The SEC staff's approach may provide even greater incentives for foreign advisers to register and provide their services to United States clients.

Investment Companies

The Investment Company Act of 1940 (ICA) requires registration with the SEC of all non-exempt investment companies. Investment companies required to register under the Act are subject to statutory provisions that regulate, among other things: composition of management and management's accountability to shareholders; approval of investment advisory contracts; changes in fundamental investment policies; transactions between an investment company and affiliated persons; and the capital structure of investment companies.

Under Section 7(d) of the ICA, a foreign investment company (i.e., one not "organized or otherwise created under the laws of the United States or of a State") may not, in connection with a public offering, offer for sale, sell, or deliver its securities through the mails or interstate commerce unless the SEC, by order, finds that it is both legally and practically feasible effectively to enforce the provisions of the ICA against such a company. In effect, the ICA requires the SEC to find that investors in foreign investment companies have the same protections as investors in United States investment companies.

Because foreign regulatory schemes differ significantly from the ICA, most foreign funds find it difficult to meet this standard. In 1954, the SEC adopted Rule 7d-1 to set forth minimum conditions and undertakings required for a Canadian company to obtain an order under Section 7(d). All of the funds that have received exemptive orders under Section 7(d), both Canadian and non-Canadian, have complied with the substantive conditions of Rule 7d-1. Only 19 foreign funds, most from Canada, have ever received Section 7(d) orders, and the SEC last issued an order in 1973. As of March 31, 1994, only three Canadian companies and one South African company were still registered with the SEC under Section 7(d).

Because the ICA does not prohibit foreign advisers from organizing funds in the United States, a foreign money manager may organize an investment company in the United States that invests in the same type of securities as a fund it manages in its home country. A number of publicly offered United States investment companies invest in foreign securities and many of these funds have advisers or sub-advisers that are located abroad.

In its *Protecting Investors Report*, the SEC staff recommended that Congress amend Section 7(d) to provide the SEC with greater flexibility to permit a foreign fund to register and make a United States public offering. Rather than requiring a foreign fund to restructure itself to accommodate the United States regulatory system, the staff's proposal would permit the SEC to exempt a foreign fund from certain provisions of the ICA if foreign laws, or specific conditions agreed to by the foreign fund, provide investor protections that are comparable to those provided by the ICA.

The proposal to amend Section 7(d) would require the SEC to enter into a regulatory memorandum of understanding (MOU) with the securities regulator of the foreign country in which the foreign fund is organized. The SEC would use MOUs as the basis for determining that foreign laws provide an adequate substitute for specific provisions of the ICA, and as a means of addressing cooperative enforcement procedures with foreign regulators. Negotiating MOUs with foreign regulators also would provide the SEC with a specific means of addressing the question of comparable access for United States funds in particular foreign markets. As of October 1, 1994, neither the SEC nor Congress had taken any action on the proposal to amend Section 7(d), and no action is expected to be taken in the near future.

Foreign banks (and certain other foreign entities such as foreign insurance companies) may be considered investment companies under the ICA if they are sufficiently involved in holding or trading securities. Section 3(c)(3) of the ICA expressly excepts United States, but not foreign, banks and insurance companies from the definition of investment company. In October, 1991, however, the SEC adopted Rule 3a-6 under the ICA which excludes foreign banks and insurance companies from the definition of investment company. When the SEC adopted Rule 3a-6, it also rescinded Rule 6c-9, which had conditionally permitted foreign banks and their finance subsidiaries to sell their own debt and non-voting preferred stock in the United States. Finance subsidiaries of foreign banks and insurance companies are excluded from the ICA under Rule 3a-5.

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities with the SEC prior to their offer or sale unless an exemption from registration is available.

Under the Securities Exchange Act of 1934 (Exchange Act), issuers are required to register their securities with the SEC if such securities are to be listed on a national securities exchange or quoted on NASDAQ, if an issuer has registered securities under the Securities Act and the registration statement has been declared effective, or if certain asset size and shareholder number thresholds are exceeded. Once its securities are registered under the Exchange Act, an issuer must file annual reports and other periodic reports with the SEC, as well as, in the case of domestic companies, proxies and insider trading reports.

Foreign Issuers

In principle, public offering and periodic reporting requirements for foreign issuers are the same as those for domestic issuers. Thus, the federal securities laws apply the concept of national treatment to foreign issuers. In practice, the SEC has adjusted its disclosure requirements to accommodate foreign issuers because of differences in legal and accounting practices between countries.

As of June 30, 1994, 626 foreign issuers representing 40 countries were filing Exchange Act reports with the SEC. A total of 380 new foreign companies have entered the U.S. markets since January 1990, including companies from Germany, Chile, and China. Since January 1990, foreign issuers from 37 countries have registered under the Securities Act $154 billion of securities in 625 offerings.

Disclosure. Separate registration and reporting forms have been adopted under the Securities Act and the Exchange Act for use by foreign issuers. Form 20-F, which serves as both a registration statement and an annual report form under the Exchange Act, requires disclosure substantially identical to Form 10-K, the domestic issuer annual report form. As mentioned, certain accommodations have been provided to foreign issuers. These accommodations include limiting management compensation disclosure to disclosure on a group basis and requiring information on transactions by management only to the extent that such disclosure has been made pursuant to applicable foreign laws. Periodic reports need to be furnished by foreign issuers only to the extent that they are either required to be made public by applicable foreign regulations or are distributed to security holders. In addition, foreign issuers generally are not subject to the proxy solicitation regulations or regulations pertaining to insider reporting which are applicable to domestic companies.

Financial statements for foreign issuers are not required to be prepared in accordance with United States generally accepted accounting principles (GAAP), established by the Financial Accounting Standards Board, or the SEC's Regulation S-X, so long as reconciliation of significant variations from those standards is provided.[27] In all U.S. public offerings of equity

[27] Regulation S-X contains the SEC's principal accounting requirements which govern the form and content of financial statements filed under both the Securities Act and the Securities Exchange Act.

securities by foreign issuers, as well as certain other U.S. public offerings, a full reconciliation is required to be presented in accordance with Item 18 of Form 20-F. Item 18 requires the quantification and explanation of material differences in net income and significant balance sheet items and all other disclosures and supplemental data required by U.S. GAAP and Regulation S-X, including data about industry segments, foreign operations, pensions and leases. In annual reports and for certain U.S. public offerings, the issuer need only provide a more limited reconciliation in accordance with Item 17 of Form 20-F. Item 17 requires a quantification of the difference in measurement of net income and significant balance sheet items and an explanation of the nature and financial statement effects of each material difference.

Form 20-F, therefore, is the cornerstone of the foreign issuer integrated disclosure system for public offerings under the Securities Act. This integrated disclosure system allows a foreign issuer to abbreviate the disclosure presented in a prospectus through incorporation by reference of the business, financial and other information presented in Form 20-F.

The forms for Securities Act registration by foreign private issuers (Forms F-1, F-2, F-3 and F-4), together with Exchange Act Forms 20-F and 6-K, comprise the integrated disclosure system for foreign issuers. The extent to which an issuer may incorporate information from its Exchange Act reports, rather than physically presenting it in a public offering document, varies depending on the Securities Act form the issuer is eligible to use. The foreign integrated disclosure system is comparable to the domestic integrated disclosure system. The domestic integrated disclosure system is based on Securities Act Forms S-1, S-2, S-3 and S-4, and Exchange Act Form 10-K. Form F-6 is used to register American depositary shares represented by American depositary receipts, which are issued against the deposit of the underlying securities of foreign issuers.

In November 1993, the SEC adopted amendments to Regulation S-X Rule 3-19, which generally revise the requirements that govern the age of financial statements in registration statements to conform such requirements to the financial statement updating requirements of the home jurisdictions of a substantial number of foreign issuers.[28] In addition, in April 1994, the SEC adopted a number of proposals designed to simplify the registration and reporting process for foreign issuers.[29] The amendments expand the class of foreign companies eligible to use short-form and shelf registration for their securities by reducing the reporting history requirement from 36 months to 12 months, with the requirement that at least one annual report on Form 20-F be filed prior to eligibility, and by lowering the public float requirement from $300 million to $75 million. These amendments establish the same reporting history and public float eligibility thresholds for short-form and shelf registration as were adopted for domestic issuers in October

[28] See Securities Act Release No. 7026 (November 3, 1993)

[29] See Securities Act Release No. 7053 (April 19, 1994).

1993. In this respect, the commission has extended national treatment to foreign private issuers in the area of short-form and shelf registration.

In April 1994, the commission also adopted amendments to streamline the reconciliation requirements for foreign issuers. These include: accepting cash flow statements without reconciliation if prepared in accordance with International Accounting Standard No. 7; requiring foreign companies initially entering the U.S. reporting system to provide reconciled financial statement information for only the two most recently completed fiscal years and reconciled select financial information for only the two most recently completed fiscal years, and any interim periods;[30] and requiring reconciliation of the separate financial statements of significant investees and acquirees only if they exceed, under certain tests, a significance level of 30 percent.

In April 1994, the commission issued three proposals designed to further streamline financial information and reconciliation requirements for both foreign and domestic companies. [31] These include: allowing foreign issuers more flexibility in their choice of reporting currency; and reducing reconciliation requirements for foreign issuers with material operations in a hyperinflationary economy, if accounted for in compliance with International Accounting Standard No. 21. Also included is a proposal reducing reconciliation requirements for foreign issuers that have entered into business combinations where the method of accounting for the business combination and the amortization period of goodwill and negative goodwill is in compliance with International Accounting Standard No. 22. The proposals are pending.
In addition, the commission proposed to: eliminate the significance threshold based on relative asset size for requiring financial statements of a foreign or domestic equity investee; eliminate six financial schedules for domestic companies which have been eliminated for foreign issuers; and eliminate two additional financial schedules for both foreign and domestic issuers. The proposals are pending.

In June 1991, the SEC adopted a multijurisdictional disclosure system for Canadian issuers. The system is intended to facilitate cross-border offerings into the United States by Canadian issuers. Under the system, eligible Canadian issuers are able to satisfy certain securities registration and reporting requirements of the SEC by providing disclosure documents prepared in accordance with the requirements of Canadian securities regulators. A parallel system for U.S. issuers was adopted concurrently by Canadian securities regulators.

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[30] Reconciled financial statement information and reconciled select financial information previously had been required to cover five years.

[31] See Securities Act Release Nos. 7054, 7055 and 7056 (April 19, 1994).

In June 1993, the SEC retained the requirement that issuers provide a U.S. GAAP reconciliation for certain offerings and annual reports.[32] In November 1993, the SEC adopted amendments that expanded the availability of the system by eliminating the market capitalization requirement, changing the public float threshold and shortening the reporting history requirement for use of the system for certain offerings.[33] The amendments also recognize investment grade ratings assigned by securities rating organizations recognized by Canadian securities regulators. Through April 22, 1994, there were 81 filings under the Securities Act by 59 Canadian issuers using this system, registering a total of $13.51 billion of securities.

Also in June 1991, the SEC proposed for comment new registration forms and new exemptive rules to facilitate the extension of rights offerings, exchange offers and business combinations by foreign issuers to U.S. investors. As proposed, any foreign private issuer would be able to register a rights offer to its U.S. shareholders using disclosure documents prepared in accordance with home market standards. Similarly, certain exchange offers and business combinations would be able to be registered on the basis of home market disclosure documents. In addition, the proposal would exempt from registration under the Securities Act rights offers, exchange offers and business combinations involving amounts not exceeding $5 million in the United States.[34] The proposal is pending.

Exemptions from registration. Exemptions from the registration requirement exist under the Securities Act both for specific types of securities and for specific categories of transactions. For example, Section 3(a)(2) of the Securities Act provides an exemption from registration for securities issued or guaranteed by certain domestic government entities. The exemption does not extend to securities issued or guaranteed by a foreign government. Public offerings of such securities are registered under the Securities Act on Schedule B, which provides specialized disclosure requirements for such offerings.

Securities issued or guaranteed by a bank are also not subject to the registration requirements of the Securities Act. This exemption applies only to securities issued or guaranteed by banks, as opposed to bank holding companies or nonbank affiliates of banks. "Bank" is a term defined by the Securities Act to include U.S. banks. The SEC has deemed U.S. branches and agencies of foreign banks to be included in the exemption, provided they are subject to state or Federal regulation substantially equivalent to that applicable to U.S. banks doing business in the same jurisdiction.[35]

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[32] See Securities Act Release No. 7004 (June 28, 1993).

[33] See Securities Act Release No. 7025 (November 3, 1993).

[34] See Securities Act Release No. 6896 (June 4, 1991).

[35] See Securities Act Release No. 6661 (September 23, 1986).

In April 1990, the SEC adopted Rule 144A, which provides a nonexclusive safe harbor[36] exemption from the registration requirements of the Securities Act for resales of restricted securities to "qualified institutional buyers" ("QIBs")[37]. QIBs must in the aggregate own and invest on a discretionary basis at least $100 million of securities ($10 million in the case of registered broker-dealers). Banks and savings and loan institutions, whether domestic or foreign, are subject to a further requirement of $25 million in net worth to qualify as QIBs.

In October 1992, the SEC adopted three amendments to Rule 144A. They expanded the definition of the types of institutions that qualify to be QIBs to include collective and master trusts, permitted institutions to include U.S. government securities in the amount of securities held or invested, and the SEC added a note stating that an insurance company purchasing under the rule for a separate account that is not required to be registered under the Investment Company Act is deemed to be buying for its own account. [38]

In April 1990, the SEC approved an NASD proposal establishing the PORTAL system, a trading system for secondary trading of unregistered securities exempt from the registration and prospectus delivery requirements of the Securities Act pursuant to Rule 144A.[39]

U.S. and foreign issuers have had greater access to institutional buyers and the private securities markets as a result of the adoption of Rule 144A. Since April 1990, 514 issuers or guarantors, 206 of which were foreign issuers, have made 568 placements of approximately $78.1 billion of securities under the rule.

Also in April 1990, the SEC adopted Regulation S in order to clarify the extraterritorial application of the registration provisions of the Securities Act.[40] The regulation consists of a general statement of applicability of the registration provisions and two safe harbors from registration. The general statement provides that the registration provisions do not apply to offers or sales of securities that occur outside the United States. For a transaction to qualify under the general statement, both the sale and the offer relating to the sale must be made outside the United States. One safe harbor (the "issuer safe harbor") applies to offers and sales made by issuers, securities professionals involved in the distribution process pursuant to contract, their respective affiliates (other than certain affiliated officers and directors), and persons acting on

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[36] The term "safe harbor" as used by the SEC defines specific procedures which if followed ensure that the exemption from registration is valid.

[37] See Securities Act Release No. 6862 (April 24, 1990).

[38] See Securities Act Release No. 6942 (October 22, 1992).

[39] See Exchange Act Release No.27956 (April 27, 1990).

[40] See Securities Act Release No. 6863 (April 23, 1990).

behalf of any of the foregoing. The other safe harbor applies to resales by persons other than those eligible to rely on the issuer safe harbor.

State Regulation

In addition to the federal regulatory scheme described above, the 50 states have securities laws, known as "blue sky" laws. Most states require that broker-dealers and investment advisers active in the state register with the state. The forms used for such registration, however, are the same as the forms used for registration under the federal securities laws. As noted above, these forms elicit information about "control persons," and require consents to service of process, but do not otherwise distinguish between foreign and domestic firms.

Most states also require that securities offered in the state be registered with the state. Although most states have adopted the Uniform Securities Act of 1956, there are many variations among the states, meaning that issuers must register, or find an exemption from registration, state by state. This "blue sky" process does not differ substantially, however, for domestic and foreign issuers.

Summary

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to U.S. securities markets without compromising investor protection. The SEC has modified and simplified certain disclosure requirements that facilitate access to U.S. capital markets, including accepting, for the first time, cash flow statements prepared in accordance with international accounting standards. A total of 305 new foreign companies have entered the U.S. markets since January 1990, including companies from Germany, China, Chile, Venezuela, and Brazil. In addition, under Rule 144A, introduced in April 1990, resales of certain restricted securities have been exempt from SEC registration requirements; nearly half of the 514 issuers or guarantors under this rule have been foreign. Also, since 1992, the SEC has issued no-action letters that ease the conditions under which investment advisers can register in the United States and provide advice to U.S. clients without requiring a foreign parent itself to register, thus providing further incentives for foreign advisers to provide services to U.S. clients.

NATIONAL TREATMENT UNDER U.S. COMMODITY LAW

The Commodity Exchange Act (CEA) and implementing regulations, in general, regulate transactions involving futures and commodity options.[41] Under the CEA, the CFTC regulates

[41] Excluded are foreign currency options traded on a national securities exchange and all options on securities, both of which are regulated by the SEC. (See Section 2(a)(1)(B) and 4c of the CEA.)

transactions conducted on the 11 domestic U.S. futures exchanges (contact markets in futures and options). It also regulates futures and option transactions conducted for or on behalf of U.S. customers on both domestic and foreign markets.

In general, a financial intermediary engaged in transactions involving futures and option contracts regulated by the CFTC will be deemed to be subject to CFTC jurisdiction if it meets one of the following four criteria: it is legally domiciled in the United States; it is physically present in the United States; it has consented to jurisdiction; or it is considered to be conducting business in the United States. A financial intermediary considered to be conducting business in the United States need not be physically present in the United States. No distinction is made between solicited and unsolicited business.

Under the CEA, a foreign firm considered to be doing business in the United States is accorded national treatment, including equality of competitive opportunity, and is treated no less advantageously than a domestic firm.

Transactions on U.S. Markets

The CEA generally requires that futures and certain option contracts traded in the United States must be effected on boards of trade that have been designated by the CFTC as contract markets unless the transactions are otherwise exempt. Moreover, the CFTC must approve each contract for trading on a particular contract market. Essentially, the domestic regulatory program contemplated by the CEA focuses on both market and customer protection. The regulations applicable to market protection generally address prevention of market manipulations and other price distortions.

Futures Trading Practices Act of 1992 (FTPA)

Expanded exemptive authority. A significant development was the FTPA, which specifically provided the CFTC with expanded general authority to grant exemptions from the exchange-trading requirement and other provisions of the CEA in cases consistent with the public interest. On January 14, 1993, the CFTC issued final rules exempting certain swaps and hybrid instruments from CEA regulation.

In addition, the Treasury Amendment of the CEA states: "Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."
See section 2(a)(1)(A)(ii) of the CEA. Treasury and the CFTC have expressed different views of the scope of the Treasury Amendment. The scope of the amendment is the subject of on-going litigation.

In addition to statutory exclusions, the CFTC has the authority to grant specific exemptions under Section 4(c) of the CEA.

The CFTC modified its "hybrid instruments" rules by expanding its 1989 statutory interpretation, which applied to hybrid instruments that combine elements similar to those of commodity futures or option contracts with debt or depositary instruments.[42] Under the new rule, a quantitative test was applied to hybrid instruments to determine the predominant nature of the instrument. Instruments for which the commodity exposure is less than the value of the commodity-independent payments, and that meet the other criteria of the rule, are exempt from CFTC regulation. The rule incorporates a list of "appropriate persons" who may enter into hybrid transactions, based on, among other things, financial qualifications, or the applicability of appropriate regulatory protections.

The "swaps transactions" rule[43] pertains to agreements between two parties exchanging a series of cash flows measured by different interest rates, exchange rates and/or prices with payments calculated by reference to a principal base (notional amount). In enacting the 1992 legislation, Congress directed the CFTC to act promptly in issuing an exemption that would improve legal certainty in this area of derivatives.

The rule creates a new Part 35 of CFTC regulations, which exempts swap transactions that meet certain criteria. The new regulations exempt such transactions from most of the provisions of the CEA. Specifically, the new Part 35:

- adopts a definition of "swap agreement," which is intended to reflect the diversity of swap transactions in the marketplace;

- determines which entities or "persons" may and may not enter into swap agreements as "appropriate persons;"

- provides that swaps may not be part of a fungible class of agreements that are standardized as to their material economic terms;

- requires that the credit-worthiness of any participant be a material consideration in entering into or determining the terms of the swap agreement;

- provides that a swap agreement may not be entered into and traded on any physical or electronic transaction execution system in which market makers and other participants can simultaneously effect transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility; and

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[42] See 58 *Federal Register* 5580 (January 22, 1993).

[43] See 58 *Federal Register* 5587 (January 22, 1993).

- provides that any qualifying swap agreement entered into on or after October 23, 1974, is within the exemption provision.

The CFTC again used its exemptive authority provided by the FTPA on April 13, 1993, to issue a final order exempting from regulation certain contracts for the deferred purchase or sale of certain specified energy products which extended the relief granted in 1990 to the so-called Brent Market (crude oil).[44]

Regulatory protections. The FTPA also required the adoption of additional regulatory protections. The CFTC has responded to this statutory mandate by adding a number of important new rules. For example, on July 22, 1993, the CFTC approved rules prohibiting dual trading by floor brokers in futures and options markets with average daily trading volume of 8,000 contracts or more that have not been exempted. The rules incorporate standards set out in the FTPA. Under the new rules, an exchange could petition for an exemption from the prohibition on either of the following grounds: that its trade monitoring system satisfies new statutory standards or that a dual trading prohibition would harm the public interest in hedging or price basing at the exchange and the exchange will implement corrective actions to achieve conformity with those trade monitoring standards.

In addition, in April 1993, the CFTC approved final rules that require the registration of floor traders. Under these rules, floor traders are subject to the same background and fitness checks as other registrants. The CFTC determined to defer consideration of whether to apply these rules to persons using electronic systems. In May 1993, the CFTC enacted new rules pertaining to "broker associations," which require such entities to register with their respective contract markets pursuant to contract market rules.

In October 1993, the CFTC issued a rule implementing section 214 of the FTPA to make it a felony for employees and governing members of self-regulatory organizations (SRO) to disclose or trade on inside information and for "tippees" of such insiders to trade on inside information so disclosed. Among other things, the rules would prohibit any employee, member of the governing board, or member of any committee of an SRO from trading commodity interests based on material, nonpublic information or from disclosing such information for a purpose inconsistent with the person's official business. The CFTC has also issued regulations pursuant to the FTPA that, among other things, establish standards for SRO governance, require ethics training for registrants and suspension of registrants with felony indictments, and govern exchange emergency actions.

Customer protection. The CEA and its implementing regulations establish a comprehensive regulatory structure applicable to all regulated persons in order to prevent fraud and other

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[44] See 58 *Federal Register* 21286 (April 30, 1993)

wrongful conduct involving contracts for sale of futures and commodity options. This customer protection aspect of the regulatory regime includes:

(1) *Registration requirements intended to ensure the "fitness" of all persons who deal with customers or customer funds.* The CEA regulates the following categories of registrants[45]:

Futures commission merchant (FCM),
Introducing broker (IB),
Commodity trading advisor (CTA),
Commodity pool operator (CPO),
Associated person (AP),[46]
Floor broker (FB),[47]
Floor trader (FT) or local,[48]
Broker association,[49]

(2) *Minimum financial requirements for financial intermediaries that handle customer funds.* These requirements address the financial integrity of the markets and persons transacting business on such markets. They ensure that firms have sufficient funds to operate the business and have some financial stake in their business and that in the event of customer default, there will exist a cushion so that other customer funds will not be adversely affected.

(3) *The strict segregation of customer funds from the funds of the financial intermediary that carries the customer account.* A primary purpose of this requirement is to prevent the use of customer funds for purposes other than those

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[45] The CEA and CFTC rules now requires that registrants receive periodic ethics training. See 58 *Federal Register* 52637 (October 12, 1993).

[46] An AP is any person who is associated with the above categories of registrants who solicits or accepts customer orders or who supervises any person engaged in such activities.

[47] An FB is any person who executes orders for another person for the purchase or sale of any commodity for future delivery on the floor of a contract market.

[48] An FT is an exchange member who executes his own trades by being personally present in the pit or place for futures trading.

[49] A brokers association is composed of two or more members who (1) share responsibility for executing customer orders, (2) have access to each other's unfilled customer orders as a result of common employment or other types of relationships, or (3) share profits or losses associated with their brokerage or trading activity.

specified by the customer and to provide protections to such funds from creditors of the carrying firm in the event of its default.

(4) *A comprehensive sales practice program* to prevent fraudulent and misleading sales practices in the marketing and handling of customer accounts.

(5) *Compliance activities* undertaken by the CFTC and the SROs subject to its jurisdictions. The CFTC oversees and supervises the exchanges and National Futures Association (NFA) and imposes specific regulatory responsibilities on these SROs. These SROs in turn are required by statute and CFTC regulations to maintain extensive affirmative programs to assure the integrity of the markets and the participants they supervise. The SROs are subject to the CFTC enforcement action for failure to comply with CFTC requirements.

(6) *Record-keeping and reporting requirements.* These are intended to assist in determining whether a registrant is acting in accordance with the provisions of the CEA and the rules, regulations, and orders thereunder.

Any person, whether domestic or foreign, who conducts business on a domestic futures market for a U.S. customer is subject to compliance with the full panoply of customer protections described above.

When a person conducts business on a domestic market for a foreign customer, however, the determination as to whether that person is subject to CFTC regulation generally is a function of where that person is deemed to be located. For example, if the person conducting business is deemed to be located within the United States, that person will be required to register and otherwise comply with all of the CFTC's regulatory requirements applicable to registrants. If the person is located outside of the United States and is acting on U.S. markets in the capacity of, for example, an FCM with respect to foreign customers, that person may be subject to reporting requirements as a "foreign broker."

"Foreign brokers" generally are defined as persons located outside of the United States that carry an account in futures or options for or on behalf of non-U.S. persons on U.S. markets through a carrying FCM. The CFTC staff has not required foreign brokers to register with the CFTC as FCMs; however, they remain subject to, among other things, the above-referenced reporting requirements. The commission similarly has stated that a foreign broker acting in the capacity of an introducing broker would generally not need to register as an introducing broker.

The commission's staff has taken a similar position with respect to persons located outside the United States who act in the capacity of a CPO or CTA. Specifically, the CFTC's staff has stated that it would not recommend enforcement action against such persons for failure to be registered in the appropriate capacity provided such persons, among other things, confine their

activities subject to regulation to an area outside of the United States and to clients who are neither U.S. residents nor U.S. citizens.

With respect to FCMs and IBs, most foreign firms that desire to engage in such activities choose to do so by means of a U.S.-based subsidiary or affiliate which, among other things, facilitates U.S. client contact. In addition, the CFTC's staff has indicated that an offshore applicant's failure either to maintain an office in the U.S. or to demonstrate that it has procedures to ensure CFTC and National Futures Association (NFA) access to its books and records may constitute grounds upon which registration may be denied.

Transactions on Non-U.S. Markets

Prior to 1987, the sale of foreign futures to U.S. customers was essentially unregulated. Thus, firms in the United States and overseas could offer and sell these products to U.S. customers subject only to a general antifraud provision. The offer or sale of foreign options, with minor exceptions, had been banned since 1978. In 1987, the commission promulgated a comprehensive set of regulations, the Part 30 rules, which govern the offer or sale of any foreign futures or options contract to a person resident in the United States.

Among other things, the Part 30 rules provide a mechanism by which the ban on the offer or sale of foreign options may be lifted on the market-by-market and product-by-product basis. These rules apply to any person, whether a U.S. or non-U.S. resident, who engages in the above-mentioned activities with respect to a customer resident in the United States. Persons who transact business for U.S. customers on foreign markets will be required to register in the appropriate capacity. The rules generally parallel the CEA's registration requirements for persons who act in the capacity of an FCM, IB, CTA, or CPO. In effect, these rules extend existing customer protection regulation of domestic products offered in the United States to foreign futures and option products with respect to registration, sales practices (including disclosure), capital adequacy, protection of customer funds, compliance and record-keeping and reporting requirements.

There are two areas in which the CFTC's Part 30 rules depart from the regulatory regime applicable to domestic transactions. First, persons who act in the capacity of an IB from a location outside the United States may be exempted from the CFTC's registration requirements, provided that all of their U.S. customer accounts are carried by or through a U.S. FCM or a firm with a rule 30.10 exemption (see below) on a fully disclosed basis. Such persons must otherwise comply with certain other requirements of the CFTC's regulations (e.g., the risk disclosures requirement of CFTC rule 30.6). Such persons also must enter into an agreement, filed with the NFA, with an appropriate agent for the purpose of receiving communications from the CFTC, the Department of Justice, relevant SROs and customers who do business with such persons and provide to the CFTC and the Department of Justice access to their books and records within 72 hours of the request.

The second area in which the CFTC's regulatory regime for foreign transactions differs from that applicable to domestic transactions relates to persons acting in the capacity of an FCM. Specifically, such persons may apply for an exemption from the FCM registration requirement by virtue of the "comparability" of the regulations in effect in the jurisdiction in which such persons are located.

Comparability

Under the CFTC's rule 30.10, persons located outside the United States, who solicit or accept orders and related funds from U.S. customers for foreign futures or options transactions, and who are subject to a *comparable regulatory scheme* in the jurisdiction in which they are situated, may apply for an exemption from the application of certain of the Part 30 rules applicable to such transactions. To date, 127 comparability petitions have been filed by foreign regulators or SROs on behalf of members and/or the firms that they regulate.

To accommodate the increasing internationalization of futures markets and the CFTC's desire to facilitate cross-border transactions, the comparability approach to exemptions permits substitution of the regulatory system of another jurisdiction for that imposed in the United States. It is an effort both to avoid duplicative regulation of a foreign person and to avoid regulatory gaps. The foreign jurisdiction's regulations provide protections to customers that are at least comparable to those in effect in the United States. The reasons for the comparability approach include the following:

- It is intended to assure that a U.S. customer receives similar protection with regard to the offer and sale of commodity futures and option products regardless of the market on which the product is traded.

- It permits a firm based in a jurisdiction that has a comparable regulatory program and that monitors its firms for compliance with such requirements to comply, for the most part, with requirements imposed by its jurisdiction of domicile (thus acknowledging that the home jurisdiction of the firm is in the best position to monitor the firm for compliance).

- It provides flexibility in that it permits the CFTC to address both regulatory duplication and gaps. The comparability approach is not intended to reach the design of foreign products, or the trading, clearing, margining, or settlement rules of foreign markets.

The CFTC's comparability program requires a two-tiered analysis. First, the CFTC reviews the rules and regulations of the applicable foreign regulator or SRO and will grant exemptive relief based upon an assessment that the regulations serve as an adequate substitute for

compliance with U.S. rules and regulations.[50] The CFTC has broad discretion to determine that the purposes of any program element generally are met, notwithstanding the fact that the offshore program does not contain an element identical to that of the CFTC's regulatory program. In considering each petition the CFTC's staff has consulted extensively with foreign regulators and SROs in assessing the comparability of the foreign regulatory regime.

Second, as a condition of granting comparability relief to a specific firm, the CFTC requires that each firm requesting exemptive relief must be sponsored by its regulator or SRO and must provide certain consents and representations.[51] The "comparability" exemption, however, does not exempt any person from other obligations under the CEA and regulations thereunder, including the antifraud or risk disclosure obligations contained in the foreign futures and option rules.

To date, the CFTC has approved the petitions submitted by exchanges, SROs, and governmental entities in six jurisdictions: Australia — Sydney Futures Exchange; Singapore — the Singapore International Monetary Exchange (SIMEX); Canada — the Montreal Exchange and the Toronto Futures Exchange; France — the Commission des Operations de Bourse on behalf of the Marche a Terme International de France (MATIF); Japan — the Tokyo Grain Exchange; and the United Kingdom — the Securities and Investments Board (SIB), the Securities and Futures Authority (SFA), and the Investment Management Regulatory Organization (IMRO). So far, these SROs and governmental entities, in conjunction with the CFTC, in turn have designated well over 100 firms as eligible for comparability relief.

CFTC staff is currently reviewing petitions submitted for relief under rule 30.10 by the New Zealand Futures and Options Exchange (NZFOE), the Mercado Espanol de Futuros Financieros Derivados de Renta Fija, S.A. (MEFF) and the Kuala Lumpur Commodity Exchange.

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[50] The minimum elements of a comparable regulatory program include: (a) registration, authorization or other form of licensing, fitness review or qualification of persons through whom customer orders are solicited and accepted; (b) minimum financial requirements for those persons who accept customer funds; (c) protection of customer funds from misapplication; (d) record-keeping and reporting requirements; (e) minimum sales practice standards, including disclosure of the risks of futures and option transactions, in particular the risk of transactions undertaken outside the jurisdiction of domestic law; and (f) compliance mechanisms.

[51] These consents and representations include, among other things: consent to jurisdiction in the United States by filing an appointment of an agent for service of process; consent to provide immediate access to its books and records (which may be effected through a foreign regulator); consent to participate in an arbitration program implemented by the NFA for nonmember firms in connection with customer disputes involving foreign futures and options; consent that all futures or options transactions will be made on or subject to the rules of an exchange located outside the United States; representation that no principal of the firm would be disqualified from doing business under the CEA; and disclosure of the identify of any U.S. affiliate or subsidiary that is engaged in a related business.

In October 1992 and August 1994, the CFTC issued orders permitting foreign firms that have comparability relief under rule 30.10 to engage in limited marketing activities of foreign futures and option products from locations within the United States. Previously, rule 30.10 relief was available only to qualified firms subject to a comparable regulatory regime that solicited customers from a foreign location. The CFTC orders interpret rule 30.10 relief more expansively to allow 30.10 exempted firms and their employees or other representatives to market foreign futures and option products to qualified customers from a United States location, under certain circumstances. Relief under this order is initially limited to firms with 30.10 relief whose:

- regulatory or self-regulatory organization agrees to supervise such firms' regulated market conduct in the United States;

- marketing activities in the United States do not in the aggregate exceed 30 business days in any calendar year; and

- U.S. customers are persons who have a high degree of sophistication and/or substantial financial resources as specifically provided in the order.

The CFTC has determined that the October 1992 limited marketing order is applicable to members of the Montreal Exchange, France's MATIF, the United Kingdom's SIB, SFA and IMRO, and the Sydney Futures Exchange.

Electronic Trading and Internationalization of Markets

With the advent of international computer linkages, novel questions have arisen with respect to the CFTC's jurisdiction. Globex, a computerized trading system of the Chicago Mercantile Exchange (CME), was approved by the CFTC on February 2, 1989. On June 8, 1992, the CFTC approved rules implementing Globex trading on the Chicago Board of Trade (CBOT).

Globex is an electronic trade execution system developed by the CME and Reuters for the trading of CME contracts outside regular business hours. Globex brings buy and sell orders together by linking individual terminals where orders are entered with a central computer. Each terminal displays current market information such as the prevailing bid and ask prices and the quantity at those prices. Orders entered into the system are executed in accordance with strict rules of priority, based on price and time of entry. A single-price opening procedure is used at the start of each Globex session.

Globex trades CME products in accordance with relevant exchange rules and it licenses terminals to members or certain "member affiliates" for such trading in several jurisdictions. Trading commenced in both CME and CBOT contracts on June 25, 1992.[52]

On October 16, 1992, the CME and the MATIF, with the approval of their respective regulators, agreed to implement an innovative cross-access program on the Globex electronic trading system. Under this program, which the CFTC approved in September and MATIF approved in October: (1) Certain products of the CME and the MATIF will trade side-by-side on Globex screens located in France and the United States, and (2) members of the CME and MATIF with access to Globex screens will have the ability to trade each other's contracts without becoming members of the other exchange.

The CME/MATIF cross-exchange access program effectively applies a "lead regulator" concept to cross-border exchange access. Each participating exchange remains responsible for monitoring its own market consistent with its own law and for monitoring its own members access to the other exchange's contracts.
The CFTC staff has opined that the mere presence of Globex terminals in the United States should not cause the CFTC to deem any foreign exchange for which products are listed through that system to be a "domestic" exchange for which contract designation and U.S. regulation are required. However, the staff also expressed concern that the relationship between the foreign exchanges and U.S. customers may raise regulatory concerns that the CFTC might not consider internal exchange affairs. Consequently, the staff has stated its opinion that the CFTC may review any proposal to trade contracts of a foreign exchange through Globex in light of the CFTC's obligations under the CEA to maintain the integrity of the U.S. markets and to provide for the protection of U.S. customers. For example, the CFTC may review such proposals to determine whether access to information necessary to meet its own responsibilities under the CEA would be adequate.

In anticipation of the placement of Globex terminals in the United Kingdom, the CME had applied to the U.K. Department of Trade and Industry (DTI) for recognition as an overseas investment exchange (OIE) under the Financial Services Act of 1986. That recognition order was issued by DTI on August 18, 1989.

On June 25, 1992, the CFTC's Division of Trading and Markets granted relief from the application of certain registration requirements that otherwise would apply to exchange member firms and their foreign affiliates in certain jurisdictions that "pass the book" of customer orders for entry into Globex. The June 25, 1992, letter permits CME and CBOT member firms to conduct Globex-related customer business through the offices of their foreign affiliates without the affiliate separately registering with the CFTC. The purpose of the relief is to allow firms

[52] The CBOT withdrew from the Globex partnership with CME and Reuters in 1994.

the flexibility to provide continuous access to Globex trading without maintaining duplicative staffing in the U.S. and Europe (initially, in France and the United Kingdom).

By letter dated August 9, 1993, this no-action relief was modified to clarify that it was not intended to be inconsistent with applicable foreign laws. On August 20, 1993, the Division of Trading and Markets issued a no-action letter that extended the relief granted to Globex orders passed to exchange member firms' affiliates in Hong Kong with Globex terminals and on December 31, 1993, the division confirmed that the relief is applicable in connection with Globex terminals in Japan. The relief granted does not alter the requirement that any foreign affiliate doing U.S. customer business on its own behalf must be registered with the CFTC.

On December 17, 1992, the CFTC approved the New York Mercantile Exchange's (NYMEX) American Computerized Commodity Exchange System and Services, known as NYMEX ACCESS. NYMEX ACCESS is an electronic order entry and trade matching system for transactions in futures contracts and options on futures contracts that will be available in major financial centers throughout the world. NYMEX ACCESS terminals are available to exchange members at locations in the United States and the United Kingdom. In particular, in June 1993, NYMEX received recognition as an OIE from HM Treasury under the Financial Services Act of 1986.

On October 29, 1993, "pass-the-book" relief similar to that provided to the CME and CBOT (referenced above) was extended to the NYMEX and its foreign affiliates in the United Kingdom who "pass the book" or otherwise handle customer orders for entry into the NYMEX ACCESS trading system.

Memoranda of Understanding

During the past few years, the CFTC has cooperated with a large number of foreign regulatory authorities through formal MOUs and other arrangements to combat fraudulent and other prohibited practices that could harm customers or threaten market integrity. To further these efforts, the CFTC has entered into regulatory and enforcement MOUs and cooperative arrangements with regulators in many jurisdictions, including Canada, the United Kingdom, France, the Netherlands, Spain, Brazil, Australia, Singapore, Taiwan, Hong Kong, and Japan. The CFTC is currently in the process of negotiating formal arrangements with futures regulatory authorities in several other jurisdictions. The commission also exchanges information and cooperates in enforcement and regulatory matters on a case-by-case basis with foreign regulatory, law enforcement, and self-regulatory authorities in many countries.

The CFTC views information sharing and other cooperative arrangements as vehicles to permit the Commission to protect better the integrity of the markets and their participants by addressing cross-border fraud and assessing more accurately the financial risks of market participants, including the potential cross-border effect of within-border financial problems. For example,

the CFTC's MOUs typically provide for access to official documents and information already in the possession of the authorities. The most recent enforcement agreements also provide the ability to obtain documents and to take testimony of, or statements from, witnesses. Recent financial information-sharing agreements, known as FISMOUs, which previously had provided a basis to exempt firms from the application of one jurisdiction's capital requirements now include risk assessment of related firms located in different jurisdictions.

Summary

In the area of financial futures, options and other derivatives, in implementing the Futures Trading Practices Act of 1992, the CFTC enhanced the legal certainty of novel derivative instruments, such as "hybrids" and swaps. The CFTC also implemented measures to facilitate 24-hour trading of U.S. and foreign exchange-traded products on approved electronic trade execution systems through programs like "cross-exchange access," which permits members of one exchange to have access to products traded on another exchange without becoming a member of the other exchange, and "passing the book," which permits U.S. exchange member firms to authorize their customers to contact their foreign affiliate with a trading terminal to trade U.S. contracts during hours when the exchange floor is closed. Finally, the CFTC continued to facilitate access by U.S. customers to foreign risk management instruments through innovative programs such as comparability relief, which exempts foreign firms from CFTC regulations on the basis that they are subject to comparable regulatory schemes by home country authorities.

NATIONAL TREATMENT IN INSURANCE

The U.S. insurance regulatory system protects insurance buyers and third parties. Insurance laws and regulations are designed to prevent or to minimize the adverse impact on consumers of insurer insolvencies, to ensure that rates are adequate for insurance companies but not excessive and not discriminatory, to ensure that claims are handled promptly and fairly, and to prevent unfair and deceptive marketing practices by insurers and their intermediaries.

The primary responsibility for regulation of the U.S. insurance sector rests with the states, rather than the federal government. Congress formalized this in the McCarran-Ferguson Act of 1945. Section 2(a) of the act provides: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business."[53] The act further provides that the business of insurance is exempt from federal antitrust laws except to the extent that it is not regulated by the states.

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[53] 15 U.S.C. 1012(a)

The McCarran-Ferguson Act does not prevent Congress from legislating in the field of insurance, but it does require that federal legislation specifically relate to the business of insurance. The federal government exercises control over significant aspects of the insurance business through its legislative and administrative activities in areas such as taxation, securities regulation, health care for the elderly and poor, regulation of employee pension and welfare plans, and environmental protection, as well as the enforcement of antitrust laws. The federal government also is responsible for relations with foreign governments on insurance trade issues.

For the purposes of this discussion, the following terminology is used:

- *Non-U.S. insurers*, or *alien insurers*, are incorporated in a country other than the United States. They may be U.S.-owned.

- *U.S. insurers* are incorporated in the United States, and may be foreign-owned.

- *Domestic insurers* are those insurers incorporated in the home state in which they are operating.

- *"Foreign" insurers* are insurers that are incorporated in a U.S. state outside a host state in which they are licensed to operate. They may be owned by a U.S. or a non-U.S. parent.

- *U.S. branches* are state-licensed branches of insurance companies incorporated outside the United States.

State Law and Regulation

Each state is responsible for regulating the insurance business within its jurisdiction. Each state insurance department is directed by a chief administrator who is typically an insurance commissioner. All chief administrators belong to the National Association of Insurance Commissioners (NAIC).

To minimize insurer insolvencies, states have comprehensive insurance laws and regulations governing the financial operations of licensed insurers. These laws and regulations include, among other things, minimum capital and surplus requirements, recently devised risk-based capital requirements, limitations on the size of risk retained, investment limitations, reserve requirements, rules on acceptability of reinsurance, and restrictions on the payment of dividends. In addition to monitoring the financial condition of insurers and to ensuring compliance with laws and regulations, states periodically conduct (every 3 to 5 years) onsite financial exams.

States also have promulgated regulations governing how insurance providers (including insurance companies and their agents and brokers) operate in the marketplace. These regulations are monitored by state regulatory agencies through the handling of consumer complaints and periodic market conduct investigations. Insurance providers that violate these regulations may be subject to fines, revocations of licenses, and other penalties.

Another responsibility of the insurance regulatory system is to ensure the availability of those types of insurance closely associated with social policy objectives. The states and the U.S. private insurance sector have established residual market mechanisms for certain types of coverage that are not available or are not sufficiently available in the marketplace. Most states have established such mechanisms to make available automobile and selected types of property coverage to those unable to obtain them in the normal commercial market. A few states have also established state-run workers' compensation funds, acting either as the exclusive provider or as the insurer of last resort.

Not all insurance is written by licensed insurers established in the United States. Moreover, some types of coverage are available only through unlicensed or "nonadmitted" insurers, many of which are non-U.S. insurers.[54] For example, marine insurance, reinsurance, and surplus lines insurance are often written on a nonadmitted basis. Surplus lines insurance, by definition, is available on a nonadmitted basis, and consists of types of coverage that admitted insurers cannot or will not provide. Insurance written on a nonadmitted basis is not protected by guaranty funds established by all states to ensure that policyholders' claims will be met in the event of an insolvency.[55]

To protect their citizens who purchase insurance provided on a nonadmitted basis, states have set up certain financial and managerial standards that nonadmitted insurers must meet. States enforce these standards through specially licensed agents and brokers through which such insurance must be placed, or, in the case of reinsurance, through special rules for primary insurers that use reinsurance.

Role of the NAIC. Many state insurance statutes make direct reference to the NAIC and its models, procedures, and services. The NAIC has no formal legislative authority, but exercises considerable authority and influence through its model insurance laws and regulations and through its extensive coordinating activities, including design of uniform financial reporting forms. For example, the NAIC is responsible for coordinating and conducting financial examinations of multistate insurers.

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[54] A nonadmitted insurer is one that a has not been licensed to establish a presence by a particular state, although it may be legally established in another state.

[55] Similar to deposit insurance for banks, guaranty funds ensure policyholders' claims will be met in the event of insurer insolvency. They are usually created by state law and administered by the industry.

NAIC models strive to promote uniformity among state insurance laws and regulations to raise the level of regulatory protection while reducing the regulatory burden on the industry and facilitating the ability of insurers to do business across state lines more readily. In 1990, for example, the NAIC began to develop specific baseline financial regulatory standards. States that meet these standards become NAIC accredited. As of September 1994, 37 states had been accredited.

Treatment of Non-U.S. Insurers

Non-U.S. insurance providers that seek to enter and operate in the United States generally receive national treatment including equality of competitive opportunity. This applies to branches of non-U.S. insurers as well as their subsidiaries.

Non-U.S. insurers may choose to form or purchase a separate subsidiary which would thereafter be designated a domestic or foreign insurer. Some U.S. states require a majority of the directors or incorporators, or both, of an insurer to be U.S. citizens. This requirement does not appear to have diminished the ability of non-U.S. insurers to enter or compete in the United States. Once established, foreign-owned U.S. insurers face no operating restrictions that are different from those faced by U.S.-owned insurers.

U.S. branches of non-U.S. insurers must furnish proof that they are lawfully organized and licensed in their home jurisdiction. Some states have no mechanism for initial entry into the U.S. of non-U.S. insurers as branches. Nevertheless, non-U.S. insurers may gain admittance to any state by initially entering through another state and establishing additional branches in the states that lack the necessary mechanism for approving initial entry into the United States of branches of non-U.S. insurers.

To help assure the ability of all insurers to satisfy their obligations, all states require the placement of specific deposits with the state treasurer or a state-recognized institution.[56] These deposit requirements ensure that liquid assets are available to satisfy the claims in the event of a default. Many states have different deposit requirements for domestic, foreign, and alien insurers. Requirements for alien insurers are often higher than for foreign insurers.

Differentiated treatment of U.S. branches of non-U.S. insurers is unavoidable because their form of organization is different from domestic and foreign insurers. Differentiated treatment exists because of strong state concern for consumer protection. Most states require branches of non-U.S. insurers to maintain trust accounts at least equal to the liabilities owed to all U.S. policyholders as the only way to protect those policyholders.

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[56] Specific deposits are usually held with the state treasurer or a qualified bank as part of the capital and surplus to be used to satisfy policyholder and creditor claims.

Many states also have statutes prohibiting the authorization of any insurer that is owned or controlled by a government, including any domestic or foreign government. Three states have laws prohibiting only foreign government-owned insurers. States enacted these statutes in response to fears that government-owned insurers would be unfairly supported or subsidized.

Foreign trade officials, representatives of non-U.S insurers and some U.S. insurers have argued that the state system of regulation itself is a market access barrier that discriminates against non-U.S. insurers. There are, for example, additional costs to meeting the requirements of 54 separate jurisdictions (i.e., 50 states, the District of Columbia, Puerto Rico, and Guam), rather than one national jurisdiction, but multi-state U.S. insurers face the same burden and must master the requirements of those states they seek to enter. Generally, the state regulatory system does not discriminate against non-U.S. insurers; they are accorded treatment no less favorable than that provided to "foreign" insurers. A company from Japan has the same ability to compete in New York that a company from New Jersey does, consistent with the principle of according national treatment including equality of competitive opportunity to non-U.S. insurance companies.

Under federal law, however, U.S. branches of non-U.S. insurers cannot provide surety bonds for U.S. government contracts. Although this is inconsistent with the national treatment standard, it is mitigated by the fact that U.S. branches can reinsure these sureties. Thus, U.S. branches can still compete for the business and service their clients.

Foreign-based insurers that provide cross-border insurance but have no U.S. presence also face some measures that have national treatment implications. Federal law imposes an excise tax on all premiums paid to foreign-based insurers and reinsurers. Because these insurers do not pay U.S. income taxes, the excise tax is considered an "equivalence" tax. Nevertheless, as these insurers also pay taxes in their home country, U.S. trading partners criticize the excise tax as burdensome.

The Future of Equality of Competitive Opportunity in Insurance

The insurance regulatory system is evolving as states continue to strengthen financial requirements for insurance providers in response to changing market conditions. These developments will have an impact on the U.S. operations of alien insurers.

States, for example, are paying special attention to non-U.S. insurance providers, who are playing a larger, more critical role in the U.S. market, largely because non-U.S. insurers have been involved in a few insurance insolvencies in the past several years. Consequently, the financial regulatory standards that the NAIC requires for state accreditation reflect greater prudential concern over the unregulated, non-admitted market.

On the other hand, the state-based system, and the NAIC model laws and baseline financial regulatory standards, will facilitate multistate expansion by non-U.S. insurers licensed in accredited states. Moreover, states seeking the additional capacity that new insurers provide to the local market, will have an incentive to accord national treatment to alien insurers.

Trade agreements covering insurance, such as the General Agreement on Trade in Services (GATS) and the North American Free Trade Agreement (NAFTA), specifically address regulatory measures that may be inconsistent with the national treatment standard. The U.S. government has consulted with the states and the NAIC extensively on these measures. This exercise has helped regulators and trade officials to understand which measures are necessary and justified for regulatory purposes and which are inconsistent with U.S. international obligations. From this understanding, future statutory and regulatory measures in insurance are likely to be drafted with enhanced sensitivity to the standard of national treatment and equality of competitive opportunity.

CONCLUSION

This chapter has examined key developments in the treatment accorded to foreign financial institutions and products in the U.S. market since the 1990 report was published. In banking, the Federal Deposit Insurance Corporation Improvement Act of 1991 strengthened the federal regulators' authority to regulate and supervise the activities of foreign banks in the United States. The statute includes the Foreign Bank Supervision Enhancement Act, which imposes a new requirement that all foreign bank applicants seeking to establish U.S. branches or agencies be subject to comprehensive consolidated supervision by their home country authorities. More recently, the Interstate Banking and Branching Efficiency Act of 1994 will provide new nationwide banking opportunities for both domestic and foreign banks.

In the securities sector, regulators have taken a number of steps to simplify access by foreign firms and issuers to the U.S. securities markets without compromising protection of U.S. investors. Disclosure requirements have been modified to facilitate access to U.S. capital markets, resales of certain restricted securities have been exempted from SEC registration requirements, and the SEC has issued no-action letters which ease the conditions under which investment advisers can register in the United States and provide advice to U.S. clients, thus providing further incentives for foreign advisers to provide services to U.S. clients.

The Commodities Futures Trading Commission continued to facilitate access by U.S. customers to foreign risk management instruments, enhanced the legal certainty of certain novel derivatives instruments, and implemented measures to facilitate 24-hour trading of U.S. and foreign exchange-traded products on approved electronic trade execution systems. In insurance, state regulators have continued to tighten solvency standards for insurance firms, generally on a nondiscriminatory basis, for prudential reasons and in order to protect policyholders.

Developments in U.S. law and regulation generally have been consistent with the principle of according national treatment to foreign financial institutions and have improved the access of foreign financial services providers to U.S. financial markets.

OPERATIONS OF FOREIGN FINANCIAL INSTITUTIONS IN THE UNITED STATES

FOREIGN BANKS

Activities of Foreign Banks in the United States

Foreign banks initially entered U.S. markets to serve primarily the banking needs of U.S. affiliates of their home country customers, much the same reason for the initial expansion overseas by U.S. banks. Foreign banks also have been attracted to the United States because of the depth and liquidity of U.S. money and capital markets and because of the role of the U.S. dollar in international trade. The presence of foreign banks has contributed importantly to the depth and liquidity of U.S. financial markets. In times of constraints on lending by U.S. banks, active participation by foreign banks in the United States has improved the supply of credit to U.S. companies.

Foreign banks have a wide range of choices of the institutional form in which they may operate in the U.S. market. As of June 30, 1994, 288 foreign banks from 60 countries operated 580 agencies and branches, 91 U.S. banking subsidiaries, 12 Edge Corporations, and six New York State Investment Companies. Agencies and branches are the preferred form of operation, accounting for over four-fifths of the assets of the banking offices operated by the foreign banks. In addition to operating through vehicles with banking powers, banks from 46 countries operate about 250 representative offices in the United States. Under U.S. law, foreign banks also are permitted to participate in a variety of nonbanking financial activities. For example, foreign banks can participate in leasing and finance companies, investment advisers, and limited purpose trust companies. Foreign banks that had securities broker-dealer subsidiaries prior to passage of the International Banking Act of 1978 had these operations grandfathered.

Foreign bank activity is concentrated in the major U.S. financial centers. New York accounts for 71 percent of the U.S. assets of foreign banks, California for 14 percent, and Illinois for 9 percent. The remaining 6 percent of foreign bank assets at U.S. offices are concentrated primarily in Miami, Houston, and Atlanta. In New York nearly 90 percent of foreign bank activity is at agencies and branches, while in California almost 40 percent of total foreign bank assets are at subsidiary commercial banks.

There also is considerable diversity in the business orientation of the nearly 300 foreign banks with a U.S. banking presence. Some banks are involved primarily in U.S. money markets, either as net investors, net borrowers, or in managing a portion of their parent banks' liquidity. In recent years, foreign banks have become more active in lending to U.S. business, often purchasing loans originated by U.S. banks. This has improved liquidity in the banking market.

Banks headquartered in industrial countries account for the predominant share of foreign bank activity in the United States. As of June 30, 1994, the reported assets of banks headquartered in the G-10 countries and Switzerland accounted for nearly nine-tenths of all foreign bank assets in the United States.

Relatively large assets also are reported at U.S. offices of banks based in large middle-income countries such as Korea, Ireland, Spain, and Taiwan and banks from the four largest Latin American countries (Argentina, Brazil, Mexico, and Venezuela) had U.S. office assets in excess of $1 billion per country.

Agencies and branches, with assets of over $700 billion as of June 30, 1994, are the most common form of operation by foreign banks. These banking offices are involved primarily in wholesale banking. They have only a small presence in retail banking. Approximately one-half of agency and branch office assets are accounted for by claims on other banks or other offices of their parent bank. Approximately 30 percent of their assets are loans to businesses or real estate loans; 12 percent of their assets are investments in securities. By contrast, less than 1 percent of their assets are consumer loans or mortgages that might be considered retail business.

On the liability side, interbank deposits and borrowings from banks account for one-half of the total liabilities of agencies and branches (the comparable number for domestic offices of U.S. banks is about 10 percent). About one-half of the interbank business of agencies and branches of foreign banks are transactions with U.S. agencies and branches of other foreign banks. Deposits, of all kinds, from nonbank U.S. residents represent only about one-eighth of agency and branch funding. (Under federal law and regulation, a federal agency cannot accept deposits; some state laws permit state agencies to accept deposits from non-U.S. residents or citizens.)

U.S. offices of foreign banks also have tended to rely on borrowings from foreign sources. As of June 30, 1994, U.S. offices of foreign banks were net borrowers of over $150 billion from foreign sources, including net borrowings of nearly $37 billion from their related offices outside the United States.

Scale of Foreign Bank Operations

From year-end 1973, the first year the Federal Reserve collected comprehensive data, through year-end 1992, the reported assets of U.S. offices of foreign banks increased from $32 billion to $870 billion, representing a compound annual growth rate of 19 percent. In 1993, for the first time since the data have been collected, the amount of U.S. assets of foreign banks actually declined to $855 billion. This decline was more than accounted for by the retrenchment in assets at U.S. offices of Japanese banks.

U.S. assets of foreign banks rebounded in 1994 and reached a peak of $872 billion as of June 30. Foreign banks currently account for about one-fifth of the assets of all banking offices in

the United States, and they have booked about one-third of all loans to U.S. businesses at these banking offices. In New York, foreign banks account for over one-half of the assets of all banking offices. In California, the foreign banks' share in banking assets is approximately one-third.

Foreign banks operate 16 banking subsidiaries in California with total domestic assets in excess of $44 billion. These domestic U.S. bank subsidiaries of foreign banks include the fourth largest bank in California (Union Bank) and four of the state's 20 largest banks. Subsidiaries of foreign banks account for about one-seventh of the business loans booked by all banks in California, and they have a portfolio of nearly 16 percent of other types of lending in that state — indicating a greater retail presence in California than in other parts of the United States.

The traditional data used since 1973 to analyze foreign bank activity in U.S. markets are limited to U.S. domiciled offices of foreign banks. Beginning in 1993, the Federal Reserve began to collect quarterly data on offshore licensed offices of non-U.S. banks that were managed or controlled by a U.S.-domiciled office of the same parent banking organization. The new reporting system for offshore branches of foreign banks indicated that as of June 30, 1994, these offshore branches of foreign banks had assets (excluding claims on their related U.S. offices) of $213 billion and loans to U.S. businesses of $56 billion. The new data on offshore lending by foreign banks increased the estimated share of foreign banks in all bank lending to U.S. businesses almost five percentage points. The new data for offshore branches also have changed the picture of the nationality of distribution of foreign banks' participation in U.S. markets. In particular, the new data reduce the estimate of the Japanese bank share of all foreign bank lending to U.S. businesses from approximately 54 percent to 39 percent, and increase the estimate of European banks' share in lending to business from 29 percent to 40 percent. While not active lenders to U.S. businesses from their offshore branches, Japanese banks use these branches as a source of funding for their affiliated U.S. offices.

Foreign Bank Lending to U.S. Business by Agencies, Branches, and Offshore Branches
June 1994

Country of Parent Bank	U.S. Business Lending (%)
Japan	36.3
France	11.6
Canada	10.5
Switzerland	8.5
Germany	6.5
United Kingdom	5.7
Netherlands	4.2
Italy	3.8
Australia	2.2
Belgium	1.2
Austria	1.1
All Others	8.0

Non-U.S. Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks ($ billions)

Year-End	Claims on Non-U.S. Residents	Liabilities to Non-U.S. Residents
1987	278.8	310.8
1988	305.1	340.4
1989	328.0	317.7
1990	326.7	384.9
1991	350.4	402.3
1992	328.9	426.1
1993	291.4	424.2
1994 June (p)	287.6	437.9

Source: Treasury International Capital Reports. Data exclude negotiable CDs.

Foreign Bank Activity in the United States
June 30, 1994

Country	Total Assets ($M)	Operating Offices	Bank Families
Japan	390,183	159	56
France	89,914	32	12
U.K.	74,645	50	13
Canada	58,568	48	6
Switzerland	44,639	17	5
Netherlands	40,488	23	3
Germany	36,067	22	11
Italy	36,022	25	13
Korea	11,910	29	8
Ireland	8,838	7	2
Spain	8,107	18	6
Taiwan	8,011	18	9
Sweden	7,556	6	4
Australia	5,550	9	6
Finland	5,550	5	5
Brazil	4,864	23	15
Israel	4,558	22	4
Austria	4,452	5	3
Belgium	3,655	4	3
Mexico	2,872	12	6
China, Mainland	2,268	6	3
Portugal	2,147	4	3
Indonesia	1,838	10	9
Denmark	1,737	4	3
Venezuela	1,614	12	6
Thailand	1,514	11	5
Singapore	1,500	9	5
Colombia	1,333	7	5
Argentina	1,177	4	3
Bahrain	1,177	3	2
Norway	1,173	3	2
Greece	1,043	5	1
Malaysia	1,004	2	2
Hong Kong	774	9	5
India	712	9	3
Bermuda	495	3	2
Uruguay	465	1	1
Kuwait	442	3	3
Philippines	400	8	5
Turkey	392	2	2
Yugoslavia	347	2	2
Pakistan	346	7	3
Ecudor	330	3	3
Panama	268	1	1
Poland	267	1	1
Costa Rica	259	1	1
Slovenia	224	1	1
Cayman Islands	223	2	1
Other	916	22	15
Total	872,834	689	288

U.S. Offices of Foreign-Controlled Banks
June 30, 1994

By type of organization:	Number	Total Assets $ Billions
Agencies	167	82
Branches	413	628
Subsidiaries	91	160
Investment Cos.	6	1
Edge/Agreement Cos.	12	2
Total	689	873
Total U.S. Commercial Bank Assets		$4,151
Percent Foreign-Controlled		21

Source: Federal Reserve

Ten U.S. Cities with the Most Foreign Banking Offices
June 30, 1994

Cities	Agency	Branch	Bank Sub.	Edge Act	Inv. Co.	Rep. Off.	Total Offices	Total Assets $bil.
New York	35	233	40	4	5	99	416	$595
Los Angeles	60	31	9	0	0	23	123	66
Chicago	0	49	5	2	0	17	73	82
Miami	1	44	2	5	0	18	70	12
San Francisco	22	10	6	1	0	11	50	52
Houston	17	0	0	0	0	18	35	5
Atlanta	22	0	0	0	0	6	28	8
Washington D.C.	0	3	1	0	0	10	14	1
Seattle	0	8	0	0	0	4	12	3
Dallas	5	0	0	0	0	6	11	2
Ten Cities	62	378	63	12	5	212	832	826
Total Foreign U.S. Offices	167	413	91	6	12	246	935	$873

Source: Federal Reserve

U.S. Assets of Foreign-Controlled Banks — 10 Leading Countries
June 30, 1994

Country	Total Assets $ Billion	Percent of Total Foreign Assets	Percent of Total U.S. Bank Assets
Japan	390	44.7	9.4
France	90	10.3	2.2
U.K.	75	8.6	1.8
Canada	59	6.7	1.4
Switzerland	45	5.1	1.1
Netherlands	40	4.6	1.0
Germany	36	4.1	0.9
Italy	36	4.1	0.9
Korea	12	1.4	0.3
Ireland	9	1.0	0.2
Total:	792	90.6	19.2

Source: Federal Reserve

Selected Assets and Liabilities of U.S. Offices of Foreign Banks [1]

	Amount ($billions)				Share of the Market [2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December 1973	32.3	17.6	12.8	11.4	3.8	3.7	7.6	1.7
December 1974	46.1	27.0	18.8	17.0	4.9	5.1	9.5	2.3
December 1975	52.4	29.9	19.9	22.6	5.3	5.7	10.4	2.9
December 1976	61.3	35.4	19.7	26.1	5.8	6.4	10.2	3.1
December 1977	76.8	41.5	22.0	33.8	6.4	6.6	10.3	3.6
December 1978	109.1	65.3	32.7	46.3	8.0	8.8	13.1	4.5
December 1979	149.6	91.9	48.2	62.8	9.9	10.9	16.3	5.6
December 1980	200.6	121.4	59.6	80.4	11.9	13.4	18.2	6.6
December 1981	250.6	157.7	73.6	101.8	13.5	15.4	19.2	7.7
December 1982	299.8	185.2	82.4	154.3	14.4	16.3	18.8	10.4
December 1983	328.8	192.4	84.5	181.3	14.6	15.6	18.3	11.1
December 1984	394.4	220.1	97.8	233.7	15.9	15.1	21.6	12.9
December 1985	440.8	247.4	108.8	236.7	16.1	15.4	22.5	12.1
December 1986	524.3	276.9	126.8	278.2	17.3	15.6	23.3	12.8
December 1987	592.6	310.9	147.9	316.1	19.0	16.6	26.4	14.1
December 1988	650.6	338.8	167.3	335.1	19.6	16.9	28.2	14.1
December 1989	735.7	369.8	184.3	376.1	20.6	17.2	29.4	14.9
December 1990	791.1	397.9	193.3	383.9	21.4	18.0	30.8	14.5
December 1991	860.7	412.3	206.4	444.5	22.6	18.9	34.5	16.2
December 1992	869.0	407.5	208.7	464.3	22.2	18.9	35.6	16.6
December 1993	855.6	383.3	196.5	468.7	21.1	17.0	33.4	16.6
June 1994	871.7	377.3	200.0	462.9	21.0	16.4	32.7	16.5

[1] Data include agencies, branches, subsidiary commercial banks and New York investment companies, but not Edge or Agreement Corporations. U.S. offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. U.S. offices of Puerto Rican banks are not included.

Sources: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

Selected Assets and Liabilities of New York Offices of Foreign Banks [1]

	Amount ($ billions)				Share of the Market [2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December 1973	22.2	12.6	9.0	8.2	13.0	12.9	19.2	6.8
December 1974	31.3	18.8	13.1	12.6	15.8	16.3	21.8	8.9
December 1975	35.8	20.5	13.8	16.4	18.3	19.0	24.6	11.8
December 1976	42.4	24.5	13.0	18.9	20.5	22.4	24.2	13.4
December 1977	54.1	28.6	14.4	25.5	22.4	24.2	25.6	16.0
December 1978	76.2	46.5	21.2	36.0	26.9	32.2	31.8	20.0
December 1979	100.6	62.7	30.6	44.9	31.1	36.5	36.5	23.6
December 1980	134.8	83.3	38.0	59.1	36.0	42.4	41.5	27.9
December 1981	149.5	96.5	44.2	61.4	37.5	42.2	40.9	29.3
December 1982	189.7	114.6	49.2	105.7	39.5	42.4	39.4	38.7
December 1983	214.3	117.9	52.1	123.6	42.4	42.4	41.2	42.4
December 1984	253.9	130.7	59.3	156.4	43.2	41.2	43.6	45.5
December 1985	293.9	153.3	66.9	166.9	44.5	43.7	47.9	44.0
December 1986	366.6	178.5	80.6	212.1	48.4	44.2	49.9	47.2
December 1987	412.0	197.1	91.8	245.5	52.5	46.7	55.6	51.5
December 1988	454.0	213.2	103.0	258.4	54.6	48.5	59.1	51.7
December 1989	511.3	224.7	111.7	290.1	57.4	48.7	60.1	54.5
December 1990	536.5	233.5	111.5	288.3	58.5	50.4	60.8	54.2
December 1991	595.7	238.1	115.0	339.0	60.5	52.4	64.2	58.6
December 1992	611.1	234.0	115.2	363.4	60.5	52.8	66.0	60.2
December 1993	607.7	218.0	109.5	368.7	59.0	50.3	65.3	60.1
June 1994	616.2	211.2	111.3	362.9	57.7	49.3	64.6	60.2

[1] Data include agencies, branches, subsidiary commercial banks and New York investment companies, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included.

Sources: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

Selected Assets and Liabilities of California Offices of Foreign Banks [1]

	Amount ($billions)				Share of the Market [2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December 1973	9.5	4.5	3.3	2.9	9.9	8.2	15.5	4.1
December 1974	13.3	7.0	4.6	4.0	12.6	11.5	18.7	5.1
December 1975	14.5	7.8	4.8	5.4	12.9	13.0	20.4	6.2
December 1976	15.9	8.8	5.1	6.2	13.5	13.9	22.3	6.9
December 1977	18.9	9.9	5.4	7.2	13.9	13.4	21.3	7.1
December 1978	27.1	14.3	8.1	9.0	16.9	15.5	25.8	7.9
December 1979	39.1	21.6	12.0	14.8	21.4	19.4	31.1	12.0
December 1980	50.1	26.7	13.3	16.1	24.2	21.1	30.9	11.7
December 1981	79.7	46.7	20.2	31.3	33.3	31.5	39.7	20.3
December 1982	86.3	53.9	23.3	38.6	33.3	32.8	39.5	22.4
December 1983	88.5	57.2	22.8	46.4	32.8	33.0	38.4	24.4
December 1984	98.8	62.9	25.0	56.4	35.0	32.6	40.3	27.4
December 1985	100.8	63.3	26.2	49.1	33.7	31.3	41.5	23.7
December 1986	98.9	61.6	26.8	40.3	30.8	28.8	38.4	18.3
December 1987	106.7	65.7	29.7	39.4	34.1	31.1	43.1	18.8
December 1988	112.9	71.6	33.5	43.4	33.2	31.5	47.1	19.1
December 1989	120.2	80.5	38.2	42.7	32.4	30.8	48.8	17.3
December 1990	135.5	94.2	44.5	47.9	33.6	31.6	51.1	18.0
December 1991	135.7	93.4	43.7	50.8	32.9	32.4	53.2	18.5
December 1992	127.0	90.0	41.7	46.9	32.5	34.3	58.9	17.8
December 1993	116.2	82.3	36.4	45.0	31.0	33.3	55.9	17.5
June 1994	118.7	82.7	36.9	45.2	31.2	33.7	56.2	17.8

[1] Data include agencies, branches, subsidiary commercial banks but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included.

Sources: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR t05 .

Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks

June 30, 1994 $ Billion	Total Including IBF
Total Assets	710.0
Cash & balances due from	143.5
depository institutions	87.5
Total Securities	50.8
Federal Funds sold	281.8
Total loans, gross	0.1
Less: Unearned income	281.7
Loans, net:	42.1
Real estate loans	41.3
Depository institutions	160.9
Commercial and Industrial	141.9
U.S. domicile	19.0
Non - U.S. domicile	37.5
Other	71.1
All other assets	13.1
Customers liab. on acceptances	43.6
Other assets	
Net due from related	75.4
depository institutions	
	710.0
Total Liabilities	
	362.6
Total deposits and/credit balances	103.8
Individuals, partnerships, corps.	77.7
U.S. domicile	26.1
Non - U.S. domicile	90.7
Comm. banks in U.S.	74.1
U.S. Br. & Ag. of fgn. bks.	16.6
Other banks	135.5
Banks in foreign countries	24.7
Foreign official institutions	7.1
Other	0.9
Certified/official checks	68.2
Federal funds purchased	116.6
Other borrowed money	38.5
Nonrelated banks in U.S.	32.9
Nonrelated banks not in U.S.	45.2
Owed to others	50.5
All other liabilities	
Net to due related depository	112.1
institutions	

Source: Federal Reserve

FOREIGN SECURITIES FIRMS

Brokers and Dealers

A broker-dealer (other than a U.S. bank) that uses the United States mail system or any means or instrument of interstate commerce to effect transactions in nonexempted securities generally must register with the Securities Exchange Commission (SEC) under the Securities Exchange Act. The SEC's policy is one of equal market access by applying the same requirements to all broker-dealers, whether U.S.- or foreign-owned, or U.S.- or foreign-resident. Registered broker-dealers are not required to report to the SEC the extent to which they are owned by foreigners.

SEC staff has identified the number of registered broker-dealers in which foreign persons probably have equity interests of 25 percent or more to be approximately 173, out of a total of about 8,000 registered broker-dealers in the United States. The total may include companies doing business in the United States from abroad. The domicile of the foreign owners of these broker-dealers are in the following countries:

Domicile of Owners	*Number of Broker-Dealers*
Australia	6
Austria	4
Bermuda	3
Brazil	1
Canada	23
Colombia	1
Denmark	1
France	13
Germany	17
Guatemala	2
Hong Kong	8
Israel	2
Italy	4
Japan	26
Luxembourg	1
Mexico	17
Norway	1
South Korea	7
Singapore	1
South Africa	3

Sweden	2
Switzerland	8
The Netherlands	3
United Kingdom	19
Venezuela	1

Foreign Participation in U.S. Corporate Underwritings

Foreign broker-dealers are permitted to lead manage debt and equity offerings in U.S. capital markets. In 1993, foreign broker-dealers lead managed 149 debt issues totalling $35.1 billion, accounting for 3.8 percent of total new debt issues. Most of the debt issues lead managed by foreign firms were asset backed securities. Foreign brokers also lead managed 33 equity issues totalling $2.2 billion, 1.7 percent of total equity issuance in the U.S. market. (Issues lead-managed by CS First Boston are not included in the foreign totals.)

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities with the SEC prior to their offer or sale unless an exemption from registration is available.

As of March 31, 1994, 588 foreign issuers representing 40 countries were filing Exchange Act reports with the SEC. A total of 305 new foreign companies have entered the U.S. markets since January 1990, including companies from Germany, China, Chile, Venezuela, and Brazil. Since January 1990, foreign issuers from 35 countries have registered under the Securities Act $127.5 billion of securities in 548 offerings.

In April 1990, the SEC adopted Rule 144A, which provides a nonexclusive safe harbor exemption from the registration requirements of the Securities Act for resales of restricted securities to "qualified institutional buyers" (QIBs). QIBs, in the aggregate, must own and invest on a discretionary basis at least $100 million of securities ($10 million in the case of registered broker-dealers). Banks and savings and loan institutions, whether domestic or foreign, are subject to a further requirement of $25 million in net worth to qualify as QIBs.

U.S. and foreign issuers have had greater access to institutional buyers and the private securities markets as a result of the adoption of Rule 144A. Since April 1990, 514 issuers or guarantors (206 of which were foreign issuers) have made 568 placements of approximately $78.1 billion of securities under the rule.

As of March 31, 1994, 601 foreign companies were listed on U.S. stock exchanges.

Investment Advisers

Under the Investment Advisers Act of 1940 (IAA), foreign investment advisers that use the United States mail system or any means or instrument of interstate commerce in connection with their business are required to register with the SEC unless an exemption is available. No particular qualifications are required for registration, and the SEC generally seeks to apply the same requirements to foreign and domestic investment advisers.

As of March 31, 1994, approximately 312 (an increase of approximately 112 from 1990) foreign investment advisers, with foreign business addresses, were registered with the SEC, out of a total of about 21,000 registered investment advisers. In addition, the SEC believes that there are a small number of foreign investment advisers who use addresses in the United States when registering.

Based on their registration forms, it appears that a substantial majority of the 312 foreign advisers — approximately 251 — have 50 or fewer clients, and that 13 of these have more than 500 clients. These 312 advisers have reported an aggregate market value of approximately $628.1 billion of client securities managed on a discretionary basis (compared to $281 billion in 1990), and $427.8 billion managed or supervised on a nondiscretionary basis (compared to $71 billion in 1990). These advisers report giving advice to a broad range of clients, including individuals, banks and thrifts, investment companies, pension and profit sharing plans, and corporations. Approximately 5 percent (compared to 12 percent in 1990) of these advisers have reported that their principal business (or the principal business of their principal executive officers) involves something other than providing investment advice.

The business addresses of the 312 registered foreign investment advisers with foreign business addresses are in the following countries:

Business Address	*Number of Investment Advisers*
Argentina	2
Australia	3
Austria	3
Bahamas	3
Belgium	2
Bermuda	6
Bolivia	1
Brazil	2
Canada	34
Chile	3
Republic of China	3

Colombia	1
Costa Rica	3
France	10
Germany	11
Gibraltar	2
Greece	1
Hong Kong	17
Hungary	1
India	2
Israel	2
Italy	3
Japan	26
Republic of Korea (Seoul)	23
Luxembourg	1
Malaysia	3
Mexico	5
Netherlands	8
Panama	1
Philippines	2
Portugal	1
Scotland	6
Singapore	4
South Africa	1
Spain	5
Sweden	1
Switzerland	5
Thailand	1
United Kingdom	104

Investment Companies

Under Section 7(d) of the Investment Company Act of 1940 (ICA), all nonexempt investment companies are required to register with the SEC. Only 19 foreign funds, most of which are from Canada, have ever received orders from the commission under Section 7(d). The SEC last issued such an order in 1973. As of March 31, 1994, only three Canadian companies and one South African company were still registered with the SEC under Section 7(d).

A foreign money manager may organize an investment company in the United States on the same basis as domestic money managers. Foreign advisers also can establish funds in the United States that invest in the same types of securities as funds they manage in their home countries.

As of December 31, 1993, the most recent date for which data are available, there were approximately 635 U.S. investment companies whose portfolios consisted primarily of foreign securities. Assets of these funds totalled approximately $175.3 billion. Of these funds, approximately 540 were open-end (funds that have a floating number of outstanding shares and stand prepared to sell or redeem shares at all times). Approximately 95 were closed-end (funds that have a fixed number of outstanding shares that are traded either on an exchange or in the over-the-counter market). Assets of open-end funds with portfolios of primarily foreign securities totalled approximately $150 billion; assets of these types of closed-end funds totalled approximately $25.3 billion.

Foreign Commodities Businesses

The Commodity Exchange Act (CEA) and the regulations thereunder regulate all transactions involving futures and certain option contracts. Under the CEA, a foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm. Any person who acts in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading advisor (CTA), commodity pool operator (CPO), or as an associated person (AP) of the foregoing must register in the appropriate capacity with the Commodity Futures Trading Commission (CFTC).

In general, a financial intermediary will be deemed to be subject to CFTC regulation if it is legally domiciled in the United States, is physically present in the United States, has consented to jurisdiction, or is considered to be conducting business in the U.S. A financial intermediary that is deemed to be conducting business in the U.S. need not be physically present in the U.S.

Under the CEA, the CFTC's policy is one of equal access. A foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm.

CFTC data, as of October 1993, indicate that the numbers of registrants who are foreign-based are as follows: 153 CTAs (6 percent of registrants), 36 CPOs (3 percent of registrants), 1,974 APs (4 percent of registrants), and 0 FCMs. The countries of origin for these registrants are as follows:

	CTA	CPO	IB
Australia	6	1	1
Bermuda	2	5	
Belgium	2		
Bahamas	4	3	
Brazil	1		
Canada	15	3	2
Costa Rica	1		
Czechoslovakia	1		
Denmark	2	1	
Ireland	2	2	1
France	6	1	
Germany Federal Republic of	13	2	
Hong Kong	2		1
Holland	2	2	
Indonesia	1		
Ireland (North)	1		
Israel	1		
Japan	32	3	1
Korea Republic of	3		
Malta	1		
Mexico	1		
Monaco	1	1	
Netherlands	4		
Singapore	1	1	
Switzerland	11	1	
Taiwan	3		
United Kingdom	31	8	1
West Indies	3	2	
Total	153	36	7

Previously, the extent to which CFTC registrants, including FCMs, were foreign-owned, directly or indirectly, in whole or in part, was unknown because neither the degree of ownership interest in, nor the address of the parent firm of the registrant, was required to be disclosed on CFTC registration documents. Since April 1993, amendments to the CFTC's registration forms now require fuller disclosure of the ownership of applicants for registration. In particular, applicants are required to disclose the identity and location of persons and entities who have a 10 percent or more interest in, or are general partners of the applicant, as well as their relevant controlling persons.

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CFTC rules also provide special treatment for firms engaging in the offer or sale of foreign futures and commodity option products to persons in the United States. Specifically, CFTC rules provide a mechanism for exempting foreign firms, upon application by relevant parties, from compliance with some CFTC rules, such as registration, based upon the CFTC's determination of comparability between the foreign jurisdiction's regulation scheme and that of the CFTC. This approach of substituted compliance is an effort to avoid duplicative regulation without having regulatory gaps. The countries of origin of these exempted firms are as follows:

Foreign Firms Granted Relief from Registration as FCMs Based upon Comparability of Foreign Regulation

Australia	17
Canada	12
France	22
Singapore	2
United Kingdom	74
	127

In granting comparability relief, the CFTC requires firms to disclose their affiliates in the U.S. that act in the capacity of a bank, a broker-dealer, or a dealer in the cash commodity. The CFTC's records indicate that the majority of the foreign firms granted relief are affiliated with such firms in the United States.

Finally, the CFTC recently proposed for comment rules that would enhance the CFTC's access to information concerning the activities of affiliates (including those located overseas) of registered FCMs. As proposed, these rules would require registered FCMs to maintain certain records concerning the financial activities of "material affiliates." (Generally speaking, a "material affiliate" is considered to be an entity associated with the registered firm whose risk exposure could impair the financial or operational viability of the registrant.) Included within these records would be an organizational chart depicting the holding company structure of which the registered FCM is a part. The chart would provide an overview of the entire organization and identify those affiliated persons that are "material affiliates" of the FCM, including those located outside the United States that may not act in any regulated capacity requiring registration in the United States, but which are affiliated with U.S. FCMs.

FOREIGN INSURANCE FIRMS

Foreign insurers participate actively and extensively in the U.S. insurance market and receive treatment on an equivalent basis with U.S. insurers.[1] Foreign insurers can establish in the U.S. insurance market as a branch or as a subsidiary. Foreign-based insurers also can write business directly on certain large commercial risks, risks that U.S. insurers will not write, or risks the insured places abroad, as permitted by the laws and regulations of each state and the federal government. Foreign-owned insurers in the United States are able to also engage in any activities allowed domestic insurers.

The United States has the largest insurance market in the world with about 34 percent of $1.41 trillion premiums worldwide in 1991 (see table). The United States led the world market for nonlife insurance, but was second behind Japan in the size of the life market. According to the Federal Reserve Board, insurance and pension funds hold nearly one-fifth of the credit market assets in the United States.

While many countries distinguish between life insurance and nonlife insurance (which includes health insurance), the major lines of business in the United States are property/casualty (P/C) insurance and life/health (L/H) insurance. More than 1,700 L/H insurers are licensed in the United States. They underwrite life insurance, annuities, and accident and health insurance, and manage pension and trust funds. P/C insurers provide financial protection for individuals, businesses for which the insured is liable. P/C insurers can write accident and health insurance, but they cannot write life insurance.

Foreign Participation in the U.S. Insurance Market

Foreign-owned insurers in the United States had sales (premium income plus investment income plus other income) of $72.9 billion in 1991, up sharply from $62.6 billion in 1990. It is estimated that foreign-owned insurers from more than 25 countries captured about 11 percent of the U.S. premium market in 1991. This is a foreign market share consistent with that of most other major markets.

Foreign-owned nonlife insurers and other insurance services had sales of more than $39 billion in the United States in 1991. Foreign-owned life insurers in the United States recorded $33.7 billion in sales in 1991. Most foreign-owned insurers in the United States are from Europe and Canada.

Cross-border trade in insurance is a small, but important part of the U.S. insurance market. U.S. based insurers received more than $5.5 billion of premiums from overseas (exports) in 1992. Premiums of $11.9 billion went to foreign-based insurers (imports) to cover risk in the

[1] Foreign insurance firms are insurance firms incorporated abroad.

United States. Most premiums sent abroad went to Europe or to offshore centers, such as Bermuda, for reinsurance. (Reinsurance is insurance that direct insurers buy to reduce their liabilities and spread their risks. Reinsurance premiums sent abroad represent about one-third of the reinsurance market in the United States. Many of the prominent domestic reinsurers are subsidiaries or branches of foreign insurers.)

Foreign-owned insurers handle much of the several billion dollars in direct insurance written in the United States on a nonadmitted (i.e., unlicensed) basis. This is mostly excess and surplus lines insurance — insurance for risks that licensed insurers are unable or unwilling to underwrite.

Foreign-owned companies have expanded their insurance activities in the United States over the past few years mainly through acquisition. Foreign outlays for acquisition or establishment of insurance companies in the United States have totalled more than $16 billion since 1981. This included $5.8 billion in 1988, largely reflecting a $5.2 billion investment by Batus Inc. (United Kingdom) in the Farmers Group, an insurance company in California. Other recent foreign investments of note include the Axa Group (France) infusion of $1 billion in the Equitable Life Assurance Society of New York, and the 1991 purchase by Allianz (Germany) of the Fireman's Fund of California, valued at $3.1 billion.

Diversification into Other Financial Services

In the United States, foreign-owned insurers can engage in other financial services to the limit of the law allowed for domestic insurers. Insurance companies can be organized as independent entities or controlled by holding companies that include other types of financial institutions. Upstream insurance holding companies can be formed by one or more stock insurance companies and are generally not subject to direct insurance regulatory supervision. In addition to their stock insurance subsidiaries, insurance holding companies are permitted to own subsidiaries engaged in virtually any other activity, except banking, which is subject to a variety of state and federal restrictions. Likewise, investment banks and other financial institutions can have insurance subsidiaries.

Through the holding company vehicle, many insurers engage in a broad range of financial service activities, including many that closely resemble banking. Therefore, although insurance companies themselves may engage only in the business of insurance and ancillary activities, the insurance holding company mechanism permits them to diversify and offer other financial service products.

Regulatory and market changes and the use of holding company structures have resulted in the emergence of insurance groups offering a broad range of financial services that the insurer's sales force often markets. These companies sell insurance, investment banking and some banklike products. For example, insurers traditionally have provided much of the commercial

lending for real estate in the United States. Insurers also offer personal loans and engage in mortgage lending. Many insurance products, such as whole life and variable life insurance, have large savings and investment components that compete directly with savings and investment products of other financial institutions. Foreign-owned insurance companies (or groups) can offer any product that domestically owned companies can offer under the law.

In summary, the United States has the largest and is one of the most open insurance markets in the world. Foreign-owned insurers have entered aggressively into the United States over the past few years to position themselves in the United States and in the growing global insurance market. Foreign-owned insurers are treated on an equivalent basis with domestic insurers and participate in the full range of services and activities allow domestic insurers.

World Insurance Markets
1991 Premiums
(billions of dollars)

Countries	Total[1]	Life	Nonlife[2]
Total All Countries	1,414.4	743.6	670.7
United States	486.8	202.9	283.9
Canada	33.9	17.1	16.7
Europe	468.6	231.7	236.9
United Kingdom	114.7	75.6	39.1
German	104.3	40.6	63.8
France	80.6	44.1	36.5
Italy	34.5	9.2	25.3
Netherlands	25.9	14.1	11.8
Spain	20.5	6.2	14.3
Asia	31.6	266.7	104.9
Japan	307.8	225.6	82.2
South Korea	31.7	25.5	6.2
Taiwan	8.3	5.8	2.5
Latin America	14.9	3.2	11.6
Mexico	3.5	1.3	2.3
Africa	15.7	10.3	5.4
Oceania[3]	22.9	11.7	11.2

[1]Numbers may not add due to rounding.
[2]Nonlife business includes accident and health insurance as well as property/casualty insurance.
[3]Include Australia, New Zealand, and South Pacific Islands.

Source: *Sigma*, 1993, Swiss Reinsurance Company.

Foreign-owned Insurers in the United States[1]
(in billions of dollars as noted)

	1985	1987	1989	1990	1991[2]
All Insurance:					
Number of Companies		1,071	1,155	1,364	1,396
Total Assets	67.2	110.1	170.6	205.6	302.9
Sales[3]	23.9	39.1	54.4	62.6	72.9
Life Insurance:					
Number of Companies	—	233	247	248	367
Total Assets	33.8	53.3	77.0	92.2	171.6
Sales[3]	10.5	16.8	22.2	26.7	33.7
Other Insurance[4]					
Number of Companies	—	838	908	1,116	1,029
Total Assets	33.4	56.8	93.6	113.4	131.3
Sales[3]	13.5	22.3	32.1	35.9	39.2

[1]Companies are members of affiliates that are 10 percent or more owned by any one foreign person. Includes branches and subsidiaries.
[2]Preliminary estimates.
[3]Sales equals premium income plus investment income plus other income.
[4]Includes nonlife insurers, agencies, brokerage firms and other insurance related companies.

Source: U.S. Department of Commerce, Bureau of Economic analysis. *Foreign Direct Investment in the United States,* various issues.

Sales of Foreign-owned Insurance Companies, 1991[1]
(in million of dollars)

Country[2]	Foreign-owned in the U.S.
All Countries	72,910
Canada	14,920
Europe	46,832
Switzerland	7,041
European Community	36,011
United Kingdom	13,872
Netherlands	8,323
Germany	5,640
Latin America[3]	-
Asia Pacific	1,074
Japan	655

[1]Sales equals premium plus investment plus other income for insurance affiliates 10 percent or more owned by any one foreign person.
[2]Country of ultimate beneficial owner.
[3]Includes offshore centers such as Bermuda and the Bahamas.

Source: U.S. Department of Commerce, Bureau of Economic Analysis. *Foreign Direct Investment in the United States*, preliminary 1991 estimates.

U.S. Cross-Border Trade in Insurance
(in million of dollars)

	1990	1991	1992
Net Export[1]	751	1,028	1,069
Direct Premiums Received	2,834	1,845	2,623
Reinsurance Premiums Received	2,009	2,192	2,900
Net Import[2]	1,910	2,450	1,373
Direct Premiums Paid	1,006	1,107	1,348
Reinsurance Premiums Paid	9,216	9,962	10,527
Net Balance of Insurance Trade	-1,159	-1,422	-303

[1]Premium receipts of U.S.-based insurance companies from foreign-base insureds net of losses.
[2]Premium payments of U.S.-based insureds to foreign-based insurance companies net of losses.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. international transaction data.

FINANCIAL SERVICES NEGOTIATIONS IN THE URUGUAY ROUND

The United States has vigorously pursued the negotiation of financial services in the Uruguay Round of multilateral trade negotiations. These efforts have been aimed at securing binding commitments from commercially important industrial and developing countries to provide substantially full market access and national treatment to foreign financial services providers. The most intensive phase of the negotiations has occurred since the last National Treatment Study in December 1990.

GENERAL AGREEMENT ON TRADE IN SERVICES

The Uruguay Round of International Trade Negotiations began in Punta del Este, Uruguay, in 1986. For the first time, negotiations to open markets to international trade included services, and in particular financial services. Negotiations were completed in December 1993, when the contracting parties to the General Agreement on Tariffs and Trade (GATT) agreed to establish the World Trade Organization (WTO), which would oversee not only the revised GATT but also the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights, and a number of related documents. The Final Act embodying the results of the Uruguay Round was signed in Marrakesh, Morocco, in April 1994.

The signatories agreed, however, to continue the Uruguay Round financial services negotiations until a date that is six months after the WTO Agreement enters into force (such entry into force may occur by January 1, 1995, but is not expected to be later than July 1, 1995). At the end of that period, countries may revise their commitments to market access and national treatment in financial services. They may also finalize exemptions from the obligation to apply the most-favored-nation (MFN) principle.

The United States currently has in place an exemption from the MFN obligation for financial services (excluding insurance) which is conditional upon the level of commitments undertaken by other participants. As agreed in December 1993, the United States will suspend application of its exemption during the initial six-month period.

NEGOTIATION OF FINANCIAL SERVICES

In the period leading up to the December 1993 agreement and since then, negotiators have met with a wide range of developed and developing countries in several hundred bilateral meetings. The United States has sought binding commitments that countries will submit their entire financial services sector to the market access and national treatment obligations of the GATS, with limited exceptions if any.

Negotiations were particularly intensive with certain key countries — Japan, Korea, Singapore, Thailand, Malaysia, Indonesia, Philippines, Hong Kong, Argentina, Brazil, Chile, Venezuela,

India, and Egypt — where there were significant barriers to market access and national treatment or where countries were unwilling to bind current more liberal practices and laws.

Negotiators also met frequently with several of the countries of Eastern Europe that are developing market-oriented economies, in particular Poland, Hungary, the Czech and Slovak Republics, and Romania. South Africa was included as political conditions changed and South Africa rejoined the international economic community.

Countries that are not members of the GATT, such as China, and more recently Taiwan, Russia, and Saudi Arabia, among others, have expressed interest in acceding to the new World Trade Organization. Negotiations concerning commitments in financial services have been underway with China for some time while talks with Taiwan began in earnest in July 1994. The United States is initiating the negotiating process with other candidates for accession.

Negotiations also were held regularly, particularly in the early stages of the talks, with a number of the member countries of the Organization of Economic Cooperation and Development (OECD). Some member countries had already achieved relatively more open markets. Negotiations centered on areas where improvements could be made or significant barriers were still maintained. These countries included the 12 member countries of the European Union, which conducted negotiations as a single party, as well as members of the European Free Trade Area (EFTA) — Switzerland, Sweden, Finland, Norway, and Austria — and other OECD-member countries — Australia, New Zealand, and Turkey.

EXTENDED NEGOTIATIONS IN FINANCIAL SERVICES

The extended financial services negotiations, which must be completed within six months after the WTO Agreement enters into force, are aimed at improving commitments to the market access and national treatment obligations of the GATS. The commitments offered in the period leading up to December 1993, although received from a wide range of commercially important industrial and developing countries, did not adequately address the barriers that prevent or impede U.S. firms' access to and operation in those countries' financial markets.

Throughout the negotiations leading up to December 1993, the United States expressed willingness to commit that its relatively open financial services markets would remain open. However, the United States also stated repeatedly that it could not accept an MFN obligation in financial services that would lock open dynamic U.S. financial markets to foreign financial service providers from key countries whose own markets would remain closed to U.S. firms.

Although commitments of many countries continued to improve throughout the final negotiations in December, they were not sufficient to address this "free rider" problem. Therefore, the United States took an exemption from the GATS obligation to apply MFN to financial services (excluding insurance) that is conditional upon the level of commitments undertaken by other

participants. This conditional exemption will enable the United States to selectively restrict future access to the U.S. financial services markets, expansion, and new operations by firms from countries with closed markets.

The United States agreed to suspend application of its MFN exemption in financial services during the period of extended negotiations for six months after entry into force of the GATS. If at the end of those negotiations, the commitments of other key countries continue to be inadequate, the United States will be free to maintain or revise its exemptions from MFN. The United States will then be able to differentiate among countries in terms of the treatment accorded to their firms with respect to their future access to the U.S. market and their right to expand existing operations and undertake new activities.

Alternatively, if other key countries provide substantially full market access and national treatment to U.S. firms, at least over some agreed timeframe, the United States would be prepared to accept a comprehensive MFN commitment in financial services. In the open U.S. market for banking, securities, and other financial services, this would guarantee for firms from all GATS signatories not only their current presence and operations in the United States, but also their future ability to enter, expand operations, and enjoy the benefits of any future U.S. financial sector reforms.

RESULTS ACHIEVED TO DATE

Results to date, while insufficient to justify the United States making a broad MFN commitment in financial services, are not insignificant. A small number of countries, mostly developed countries, have made quality commitments to market access and national treatment. Such countries include Argentina and Sweden, which removed significant barriers in the course of the negotiations and bound comprehensively their financial services sectors.

Most of the countries with which Treasury negotiated intensively during the Round introduced some new practices that improved the treatment of foreign financial service providers. In many cases the changes were limited in scope. Most countries included such improvements in their schedules of commitments.

A number of countries, including countries with relatively open markets, committed to maintain their current level of openness and to bind existing nonconforming measures applicable to their entire financial services sector.

Altogether 60 countries and the European Union have scheduled commitments in banking, securities, and other financial services, and an additional number have scheduled commitments limited to the insurance sector.

Excluding commitments in insurance, about 15 developed and developing countries have schedules that provide good commitments or commitments with only a few important shortcomings. Where deficiencies remain, sectoral coverage may be incomplete and countries may have retained a few limitations for investment screening regimes, economic needs tests, or other significant barriers. For example, countries such as Finland and Australia took significant steps to improve the quality of their commitments over the course of the negotiations, but their schedules still contain such deficiencies.

About 15 additional commercially important GATT-member countries, including Japan, Korea, other South and Southeast Asian countries, and major Latin American countries continue to have major barriers to market access or national treatment and, in some cases, their commitments do not cover important financial sector activity.

NORTH AMERICAN FREE TRADE AGREEMENT

The financial services chapter of the North American Free Trade Agreement (NAFTA) sets out rules and principles governing investments of one NAFTA country in financial institutions in another NAFTA country and trade in financial services among the three NAFTA countries. Both financial institutions and financial services are broadly defined. The Mexican government is using the financial services chapter as the means to open up its financial sector to foreign investment. However, it is doing this on a gradual basis and therefore is taking temporary or transitional reservations from some of the rules laid out in the chapter. The financial services chapter of NAFTA incorporates the provisions of the U.S.-Canadian Free Trade Agreement dealing with financial services.

Rules and Principles Governing Trade and Investment in Financial Services

The chapter provides that each of the three countries will give investors (usually financial firms) of the other two countries the *right to establish* financial institutions in their territory. Governments may require that establishment be in the form of a subsidiary and be consistent with other terms and conditions that a government imposes as long as these terms and conditions do not violate the national treatment provision.

Canada currently requires that foreign banks enter the Canadian market in the form of a subsidiary. Mexico also will require all U.S. and Canadian financial firms to establish as subsidiaries rather than as branches. The U.S. banking industry wants to have the right to establish as a branch. Mexico and Canada have agreed to review the issue of form of establishment when the United States permits Mexican and Canadian banks to have branches or subsidiaries in substantially all of the U.S. market. Canada and Mexico may tie this review to a change in U.S. law that would permit commercial and investment banks to affiliate. Such affiliations are allowed and practiced in both countries.

The chapter requires that *national treatment* be extended to financial firms of the other countries with respect to establishment, acquisition, expansion, management, conduct, operation, and sales of their local firms. The national treatment principle also applies to firms engaged in cross-border financial transactions when such transactions are permitted.

National treatment is defined as treatment no less favorable than that given local firms in like circumstances. Thus, a foreign-owned firm can be given better treatment than a locally owned firm, but a government cannot treat the foreign-owned firm less favorably than a locally owned firm.

National treatment is further defined to include the concept of *equal competitive opportunity*. This means that treating foreign-owned firms the same as or equal to local firms is not

acceptable if such treatment effectively prohibits the foreign-owned firm from doing business in that market.

The signatories also are obligated to give to all NAFTA financial firms treatment no less favorable than that given to non-NAFTA firms. This *"most favored nation treatment"* means that if a NAFTA country has a treaty with a non-NAFTA country that extends to the latter's financial firms special benefits, these same benefits must be extended to the firms of that country's NAFTA partners as well.

Within this context, NAFTA countries can enter into special arrangements with another NAFTA country or non-NAFTA countries whereby the two countries agree to recognize each other's regulation on a certain matter. This is referred to as *harmonization of regulations*. An example is the agreement between the SEC and the Ontario Securities Commission for mutual recognition of certain registration documentation.

While right of establishment and national treatment are the two key principles in the agreement, the governments have agreed to observe a number of other rules or principles that will give additional rights and assurances to financial firms and investors in the NAFTA countries.

One of these is the rule whereby the government undertakes to ensure that *self-regulatory organizations* observe the rules of the chapter when there is a legal obligation to be a member of or otherwise have access to the self-regulatory group. An example is when the securities law states that a firm must be a member of a stock exchange in order to trade shares, the government must ensure that foreign-owned firms can join the exchange.

Another is the rule whereby a NAFTA firm in another NAFTA country has a right to offer *new financial services* unless the host country determines on prudential grounds that the service should not be authorized. A NAFTA country cannot restrict the foreign-owned firm from offering a new product that has not been offered in the host country, but is available in another NAFTA country unless the host country determines, for example, that such a product constitutes a danger to the safety and soundness of the financial system.

The NAFTA countries must allow financial firms to conduct data processing outside of the country where the firm is located.

Another rule concerns *senior management and boards of directors*. Governments cannot dictate nationality requirements for top management. A NAFTA country cannot require that presidents of the subsidiaries of other NAFTA firms be of any specific nationality. Nor may NAFTA governments require that more than a simple majority of the boards of directors of a financial institution owned by investors of another NAFTA country be nationals or residents of the host country.

A set of rules concerns *transparency of regulation*. The governments obligate themselves to make all rules and regulations publicly available whenever possible before these are to go into effect. The purpose is to allow interested parties to comment and thereby ensure that foreign as well as domestic firms have the opportunity to see and provide input on proposed laws and regulations.

Additionally, the governments are to act promptly — within 120 days — on all completed applications. Governments also are to set up *points of enquiry* where interested firms can go to obtain regulatory information. If a U.S. firm has a question on how to go about opening a bank in Mexico, there is a designated office in Mexico to contact in order to obtain information on what needs to be done to establish a bank in Mexico.

While the bulk of the agreement deals with establishment and operations in another NAFTA country, a section sets out a series of rules dealing with *cross-border transactions*.

The agreement states that governments cannot take measures that restrict currently allowed cross-border transactions. This means, as Mexico permits lending from the U.S. into Mexico, it will not be able to prohibit such lending when NAFTA takes effect.

Canada has excluded the securities industry from this obligation and the United States has followed suit. The reason for this exclusion is that Canada believes that its security sector is more open to cross-border participants than the U.S. securities market. Therefore, it was unwilling to commit to this obligation unless the U.S. was willing to extend a benefit to the Canadian securities industry. The two governments were unable to reach an agreement on an appropriate exchange of commitments.

The U.S. would have preferred a more positive approach to the sale of financial services across borders. In particular, the U.S. wanted to have a positive list of services that financial firms could offer on a cross-border basis. Mexico and Canada would not agree to this approach, hence the standstill on measures that restrict cross-border trade in financial services. The three countries did agree to consult on further liberalization of cross-border trade in financial services no later than January 1, 2000.

The agreement also guarantees a "right to purchase" whereby residents of any NAFTA country can buy financial services in another NAFTA country. This does not give firms the right to actively solicit customers in another NAFTA country. Thus, while a Mexican can have a brokerage account with a securities firm in the U.S., the U.S. firm does not have the right to advertise for Mexican clients in a Mexico City daily newspaper.

The agreement has provisions for *consultations* between the governments. The three finance ministries will meet at least once a year to review the implementation of the financial services

chapter and more often if one of the Finance Ministries requests a meeting. The Commerce Department will participate in discussions concerning insurance.

The NAFTA *dispute settlement mechanism* has been adapted to deal with disputes involving financial services. If a government charges that another government has violated a provision of the financial services chapter, then the case will be reviewed by a panel of recognized financial experts rather than a panel of general trade experts.

If the governments involved maintain that the issues under dispute concern other chapters of the NAFTA as well as the financial services chapter, the panel can be composed of general trade experts and financial experts. This is called a "mixed dispute."

The financial services chapter incorporates several provisions from the investment chapter. These include provisions regarding transfers, expropriation, special formalities, denial of benefits, environmental measures and an investor-state dispute settlement mechanism.

The *transfers* provision provides that all payments relating to an investment made by an investor from another NAFTA country be free from all restrictions. This means, for example, a country cannot prohibit an investor from repatriating profits, receiving interest or liquidating his investment. Should a country impose restrictions for balance of payments purposes, the country must permit transfers related to investments to be made at a market rate of exchange. This would permit a country to maintain a multiple exchange rate system with some types of transactions being made at more favorable exchange rates than the payments associated with foreign investment.

The financial services chapter provides for exceptions from the rules and principles laid out above under limited circumstances. One is for a measure taken for reasons of *prudential regulation*. This allows regulatory officials to take measures to protect participants in the financial markets, including financial institutions, or to ensure the safety and soundness of the financial system regardless of the other provisions of the chapter and related parts of the agreement. For example, a central bank or treasury could impose special reporting requirements on banks saying that these are necessary to protect depositors.

Another exception concerns the *right of governments to conduct monetary and exchange rate policies*. None of the rules and principles in the chapter prevents a government from taking measures for monetary policy or exchange rate policy purposes as long as the measure is of general application and is not discriminatory. This means a central bank could tighten credit as long as the action does not affect foreign-owned banks more severely than locally-owned banks.

Finally, the chapter provides that each country can append *schedules* to the agreement. These schedules list state and federal laws that predate the agreement and that contain provisions that

would otherwise conflict with the agreement. Countries need not amend existing laws to make them consistent with the obligations they are undertaking.

The schedules may also contain the exceptions to the agreement's obligations that will be in place during a transition period. Mexico is using this as a means to make the opening of its financial sector to foreign investment gradual.

The U.S. Reservations and Special Commitment

The United States has reserved a number of non-conforming measures, notably the Primary Dealers Act. Non-conforming measures by California, Texas, New York, Florida, Ohio and Illionis have been reserved. Other state governments are being canvassed to determine what state laws need to be reserved.

The U.S. has made a commitment to Mexico whereby Mexican-owned financial groups that own securities firms in the U.S. that became affiliated with Mexican-owned banks with offices here through the creation of the financial group in Mexico will be exempt from the U.S. requirement for divestiture of the U.S. securities business for five years from the date of the affiliation.

The U.S.-Canadian Free Trade Agreement

The provisions of the U.S.-Canadian Free Trade Agreement that are not subsumed in the NAFTA are incorporated by reference.

The Opening of the Mexican Financial Market to Foreign Investment

As the negotiators began meeting in 1991, the Mexican government was in the process of implementing a major reform of the financial system based on legislation passed the preceding year.

The most notable aspect of this reform was a new Credit Institutions Law. This provided the basis for the privatization of the Mexican banks that were nationalized in 1982. Supplementing this was the Law to Regulate Financial Groups. This provided for the creation of financial holding companies. The financial holding companies can own banks, securities firms, insurance firms and other types of financial intermediaries.

Both laws contained provisions for allowing up to 30 percent foreign ownership, but require that a single party - foreign or domestic - own no more than 10 percent. Additionally, the Securities Law was amended to permit a similar level of foreign ownership.

While the Mexican government had opened up parts of its financial system to minority foreign participation, foreign-owned institutions continued to be blocked from having a wholly-owned operating presence in the Mexican market. NAFTA is the vehicle that will provide for this.

Mexico is opening its market by creating a new category of financial firm, calling it a "foreign financial affiliate." This new category of firm will have all the rights as domestic firms doing the same type of activities. But the size of some of these firms will be limited during a transition period, either on an individual firm basis or on a sector wide basis. The transition period began when the agreement went into effect on January 1, 1994. The transition period will end on January 1, 2000.

During the transition period, a U.S. and Canadian-owned *bank*, for example, will be subject to a maximum size equal to 1.5 percent of the capital of the entire banking system. In addition, the capital of all banks owned by U.S. and Canadian investors cannot exceed 8 percent of the market in the first year of the transition period. This ceiling rises in equal annual amounts to 15 percent in the year beginning January 1, 1999, and then disappears.

If the aggregate size of the U.S. and Canadian-owned banks exceeds 25 percent of total bank capital before January 1, 2004, the Mexican government can freeze the market share of these banks at that level for a period of three years.

After the year 1999, the limit on the size of an individual U.S. or Canadian-owned bank is removed, but no foreign bank can, through acquisition, have more than four percent of the market. The purpose of this provision is to ensure that the largest five Mexican banks, each of whose capital now exceeds four percent of the system's capital, remain Mexican-owned.

A similar regime applies to *securities firms,* but the numbers are slightly different. The size of an individual U.S. or Canadian-owned firm is limited to 4 percent during the transition period and there is no limit following January 1, 2000. The limit on the cumulative size of all U.S. and Canadian-owned securities firms rises from 10 to 20 percent in equal annual amounts during the transition period. If the aggregate size of the U.S. and Canadian firms reaches 30 percent before January 1, 2004, the Mexican government can impose a ceiling on market share, as determined by capital, at that level for a period of three years.

As noted earlier, minimum capital requirements are set on the basis of national treatment. Mexico has a "full-service" concept of a securities firm and therefore a capital requirement that is viewed as high relative to practice in the U.S. and Canada. Mexico has agreed to study the possibility of having less than "full service" securities firms within two years of the date of entry into force of the agreement.

Banks and securities firms, once established in Mexico, will be able to form *financial holding companies*. These in turn can establish a broad range of financial subsidiaries.

Leasing and factoring firms are not subject to limits on individual firm size, but are subject to an aggregate ceiling that will rise from 10 to 20 percent of the capital of all leasing or factoring firms during the transition period. No ceilings can be imposed after January 1, 2000.

Insurance companies have a special regime. U.S. and Canadian firms that owned 10 percent or more of a Mexican insurance firm as of July 1, 1992, will be able to increase their ownership up to 100 percent after January 1, 1996. Insurance firms that buy into a Mexican firm as a minority shareholder may increase their ownership in gradual steps from 30 percent now to 100 percent after January 1, 2000.

Insurance firms from Canada and the U.S. can also choose to enter Mexico through establishment of a wholly-owned subsidiary. These will be subject to an aggregate ceiling which rises from 6 percent in 1994 to 12 percent in the year beginning January 1, 1999. The ceiling is removed on the following January 1, and cannot be reimposed.

Mexico also agreed to create a new type of financial intermediary, a *limited scope finance company*. These firms can engage in consumer finance, commercial finance, mortgage lending, and credit card banking. They may not accept deposits directly from the public, but may fund themselves in the local capital markets. Assets of the foreign-owned limited scope finance companies will be subject to a ceiling equal to 3 percent of the assets of commercial banks and limited scope finance companies. This ceiling, which will be reviewed in several years, will come off in any case in the year 2000. Lending by affiliates of automobile manufacturing companies for automobiles will not be subject to this ceiling.

SYNOPSIS

This synopsis covers all of the markets surveyed in Part III with two exceptions: Canada and Mexico (these countries are members of the North American Free Trade Agreement) and members of the European Union and EFTA (these countries are implementing domestic financial services legislation consistent with the EU's Single Market Directives). A synopsis of market conditions in most EU and EFTA countries is included in Chapter 27.

SOUTH AMERICA

ARGENTINA

Banking. Changes introduced by the Central Bank in early 1994 eliminated legal constraints on the establishment, acquisition, and branching of foreign banks. However, lending limits are based on the local capital of bank branches rather than the consolidated capital of the parent corporation. Not only does this raise local operating costs, but it also can limit the range of operations that foreign bank branches can engage in. There are no legal or regulatory constraints or other impediments on U.S. banks regarding their funding activities or the introduction of new financial products. Foreign financial institutions have indicated that banking regulation in Argentina is transparent and that they have sufficient opportunity to make appropriate comments on prospective regulatory changes.

Securities. There are no restrictions on entry or operation in the Argentine securities market. Foreign firms may establish either as a branch or as a subsidiary. There are no laws or rules that discriminate on the basis of domestic or foreign ownership. Nor are there any restrictions on access by residents to instruments in foreign securities markets, or on access by non-residents to financial instruments in Argentina's securities market. The regulatory environment is transparent.

BRAZIL

Banking. The Brazilian Constitution contains a prohibition on the establishment of new bank branches and subsidiaries of foreign financial institutions, as well as on increases in the percentage of foreign participation in the capital stock of a Brazilian financial institution. Although initially designed to be a temporary measure pending Congressional reassessment of the financial system, this prohibition on expansion has been in effect since 1988. The restriction is inclusive of a prohibition on the addition of Automatic Teller Machines. In addition, foreign banks face discriminatory capital requirements. Notwithstanding these constraints, there is a sizeable U.S. banking presence in Brazil. In recent years, foreign banks have been able to expand into new activities by converting into multiple banks that have broad powers, including the ability to engage in securities business.

Securities. New foreign securities/brokerage firms are prohibited from entering the Brazilian market by the same Constitutional restriction noted above. Nevertheless, foreign brokerage firms have been entering the Brazilian securities market in recent years as minority partners in joint ventures with Brazilian companies. Foreign firms established prior to 1988 were grandfathered. These foreign firms can engage in the same securities activities as domestic securities firms. However, no firm, foreign or domestic, may deal in foreign securities. Foreign firms may engage in fund management activities, but they may not sell foreign mutual funds to local investors. Brazilian financial regulation is not transparent.

CHILE

Banking. Chile has not allowed new banks, either domestic or foreign-owned, to enter the Chilean banking market since the early 1980s except through the acquisition of an existing branch. Those foreign banks already operating in Chile are guaranteed nondiscriminatory treatment in accordance with a 1960 law. The only instance of discriminatory treatment, an alternative minimum tax on branches of foreign banks, was repealed in 1993. However, foreign bank branch lending limits are based on local capital rather than on the parent company's worldwide capital. In addition, both foreign and domestic banks are restricted from engaging in fund management activities under the terms of the Banking Law. The government also has prevented any bank, foreign or domestic, from entering into new areas of business, such as pension fund management, factoring, and leasing until a fixed schedule is in place for the repayment of the debts owed to the Central Bank from nine private Chilean banks. However, banks can establish securities subsidiaries, provided these subsidiaries have no formal connection to the banks' Chilean banking operations.

Securities. Foreign securities firms face no discriminatory impediments to establishment or operation in Chile. U.S. securities firms are present as both subsidiaries and as branches. U.S. firms in Chile own and operate insurance companies and companies that manage pension funds and mutual funds. Regulation is not especially transparent, but foreign firms characterize communications with the regulatory authorities as being excellent.

COLOMBIA

Banking. Foreign banks can enter the Colombian banking market either through the acquisition of an existing bank or the establishment of a banking subsidiary. However, a foreign bank must establish a Colombian banking subsidiary before it can open bank branches. Once it is established, a foreign bank subsidiary is treated just as if it was a Colombian bank. There are no constraints on foreign banks in funding their business activities either by deposits, money market instruments, access to the Central Bank discount window, or bringing capital in from offshore via swaps.

Securities. There are no legal constraints on the establishment of securities firms either as branches or as subsidiaries. However, the U.S. presence in the Colombian securities market is limited to only one firm. That firm reports no instances of discrimination against its operations. Prior approval is required for foreign investment of 10 percent or more in the equity of a Colombian company.

VENEZUELA

Banking. Prior to this year, foreign banks were permitted to enter the Venezuelan banking market only via the acquisition of a maximum of 20 percent of an existing Venezuelan bank. Recent changes in Venezuelan law have lifted the ban on the establishment of new majority foreign-owned banks from countries that provide reciprocal access to Venezuelan banking institutions. In addition, the legislation effectively removed the previously onerous restrictions on expansion and operations imposed on established foreign banks, including the one branch of a U.S. bank.

Securities. Foreign firms may enter the Venezuelan securities market though acquisition of existing financial institutions, de novo establishment, or by branching. While there are no significant impediments to entry, U.S. presence in the Venezuelan securities market is modest, apparently inhibited by general economic conditions and the need for structural reform of Venezuela's financial markets.

ASIA - PACIFIC

AUSTRALIA

Banking. There was significant improvement in the treatment of foreign banks in 1992 when the limit on the number of foreign bank licenses was lifted and foreign banks were permitted to establish branches. However, branches are prohibited from taking retail deposits (only banks established as subsidiaries may compete for retail deposits). Imposition of an interest withholding tax on intra-bank borrowing has tended to discourage establishment in branch form. This was mitigated to some extent by a December 1993 revision in the implementation of the tax that reduced some of the impact on foreign bank branches.

Securities. Australia retains a broad investment screening test for foreign investments of 15 percent or more of a domestic firm's equity. In practice, this has not presented significant difficulties for prospective U.S. investors. U.S. financial services firms in Australia report no discriminatory impediments to their operation. They also report that regulation is transparent.

CHINA

Banking. All aspects of the Chinese banking system are heavily regulated. The People's Bank of China sets interest and deposit rates and overall bank lending is controlled administratively through the government's credit plan. Foreign banks are very limited in the range of operations that they may engage in in China. They are not permitted to conduct renminbi (local currency) business, and they may participate only in wholesale banking in such areas as letters of credit, export credits, and commercial loan syndications. Foreign banks may open branches and subsidiaries (joint ventures and wholly foreign-owned entities), but only in thirteen selected cities and special economic zones. Outside of these specified areas, banks are restricted to opening only representative offices that may not engage in profit-making activities. Despite these restrictions, U.S and foreign banks have steadily increased their presence in China over the last several years. Nine U.S. banks are currently represented in China, four of them by a total of six branches, and the others by representative offices.

Securities. Partly because the Chinese equity market is so new, China's regulatory structure is still in flux, and lack of transparency in regulations represents a significant problem to foreign securities firms. Foreign securities firms may establish representative offices, but they are not permitted to establish either local branches or local subsidiaries. (An exception is that in October 1994 a joint venture investment bank was authorized that includes U.S. participation.) Permitted activities of representative offices is limited to only brokering equity shares that are exclusively for sale to foreigners and that must be purchased in foreign currency. In addition, foreign firms are required to hire their Chinese staff through an "approved labor supplier." The major involvement of the U.S. firms in China is in underwriting offshore equity and bond issues for domestic Chinese companies; however, each new issue must receive prior approval from the Chinese government.

HONG KONG

Banking. Hong Kong has a large foreign bank presence, including 41 financial institutions from the U.S. Hong Kong is generally regarded as one of the most open and most favorable regulatory environments in Asia for foreign financial institutions. However, foreign banks established after 1978 are permitted to maintain offices in only one building (one branch). In September 1994, this limitation was modified to permit foreign banks to set up a regional office and a backoffice operation at building sites separate from the branch office. Foreign banks may acquire a controlling interest in a local bank that has unlimited branching rights.

Securities. There are no discriminatory legal constraints to foreign securities firms establishing in Hong Kong via branching, acquisition, or establishing subsidiaries. In practice, foreign firms typically establish in Hong Kong as subsidiaries. Rules governing operations are the same,

irrespective of ownership. Regulation is transparent. There are no restrictions on cross-border capital flows.

INDIA

Banking. India has a history of heavy state intervention in the financial sector that only recently it has begun to liberalize. State-owned institutions dominate the banking industry. Although there has been some regulatory relaxation, foreign banks continue to face significant obstacles to entry and expansion. In considering applications, the Indian authorities take into account the number of Indian banks present in the prospective applicant's home country. Limits on operations are tied to locally held capital, including loans made in India, rather than the capital of the parent company. In addition, foreign banks face a higher tax rate than do domestic banks. However they do benefit from lower lending targets for priority sectors.

Securities. Foreign ownership must be approved by three government regulatory agencies. In addition, foreign ownership of nonbank financial subsidiaries that engage in securities activities is limited to only 75 percent. Foreign banks can fully own merchant banks, but they are subject to discriminatory branch limitations. Foreign securities firms cannot operate on Indian stock exchanges; they must execute stock-exchange related transactions through registered domestic brokers. Foreign institutional investors are permitted to purchase equity shares of Indian companies, subject to certain ceilings, but foreign individuals and foreign corporations cannot.

INDONESIA

Banking. Since 1990, there has been little change in the treatment of U.S. banks. Reforms made in the late 1980s lifted a ban on new entry by foreign banks. However, new entry in branch form is still not permitted. In addition, foreign banks may enter the Indonesian banking market only through joint ventures with a maximum of 85 percent foreign ownership. Joint ventures face higher capital requirements than do domestic new entrants, but immediately after establishment foreign banks are able to offer foreign exchange services whereas new domestic banks must wait at least two years for approval to engage in cross-border banking activities.

Securities. Since 1988, foreign firms have been authorized to form joint venture securities firms with Indonesian partners. These JV entities, which must be at least 15 percent Indonesian-owned, can conduct all of the securities activities permitted domestic firms. However, the joint ventures are subject to discriminatory capital requirements. Other forms of entry are prohibited. No liberalization has taken place since 1988.

JAPAN

Banking. Japan generally provides de jure national treatment for foreign banks. Nevertheless, foreign banks continue to face market access difficulties, and while some are successful in particular lines of business, they remain generally limited participants in the Japanese banking market. In some instances, the business environment is hampered by the continuing problem of inadequate transparency in the Japanese rule-making and implementation process. In other instances, the business environment is made more difficult because of certain accounting and disclosure practices. A perennial problem that impedes access to the Japanese banking market is the widespread practice in Japan of exclusionary business practices. Strong relationships between members of related business groups, often involving cross-shareholding, make it very difficult for nonmembers (i.e., foreign banks) to effectively penetrate the Japanese banking market.

Securities. A variety of obstacles, both regulatory and structural in nature, have consistently prevented U.S. securities firms from enjoying a degree of success in Japan comparable to their success achieved in other major financial markets. Among the many problems, access to the domestic lead underwriting business has been non-existent; U.S. securities firms have limited freedom to innovate and offer new securities products in Japan or to market securities products in which they have a competitive advantage; Japanese investors' access to foreign financial markets and foreign securities products is constrained by law and by administrative guidance; securities firms have been prevented from offering many foreign exchange services central to their business; and in other areas where U.S. securities firms have proven expertise, such as in the management of pension funds and investment trusts (i.e., mutual funds), regulations either trivialize their role or prohibit them from competing altogether. Transparency of the regulatory system remains very inadequate. Improvements have been generally incremental and piecemeal.

As was concluded in the 1990 Report, the Japanese authorities should abandon this approach to liberalization and emphasize systemic reform. Activities should be permitted in principle, unless there are clearly identified prudential grounds for restricting them.

KOREA, REPUBLIC OF

Banking. While there has been some improvement in conditions for foreign banks in Korea, the controlled nature of the financial system and the differential treatment in a number of key areas makes it very difficult for foreign banks to fully compete. The Government has announced a five-year deregulation "Blueprint." However, the "Blueprint" did not address a number of areas of significant interest to U.S. banks, and some of the more important changes in the "Blueprint" will not occur for at least several more years.

The requirements for opening a foreign bank branch have been simplified, but there has not been adequate experience to judge how meaningful the changes will be. Other important

discriminatory measures remain in effect. Foreign banks, but not domestic banks, are required to separately capitalize each sub-branch. Branch capital, rather than parent capital, is used to define certain credit and funding limits. Access to local funding is more difficult for foreign banks, and limitations on the introduction of new financial products have the effect of restricting commercial opportunities where U.S. firms have a competitive advantage. Foreign bank subsidiaries are prohibited.

Securities. Korea imposes limits on foreign ownership of listed Korean shares. This has the effect of limiting potential growth in foreign firms' major activity in the market (i.e., the sale of Korean equities to foreign clients). The Korean government announced in October 1994 that the current limit of 10 percent would be raised to 12 percent on December 1, 1994, and to 15 percent in 1995. The government has not indicated any flexibility on when the ceiling will be removed altogether.

Foreign securities firms are allowed to establish branches in Korea, but they are not allowed to establish as subsidiaries. Branches are subject to onerous capital requirements; no provision is given to parent company capital in establishing limits on branch securities activities. By law, branches of foreign firms are not licensed to execute off-shore transactions on behalf of Korean residents. Significant restrictions are imposed on the ability of foreign firms to engage in the investment trust and investment consulting businesses. Foreign exchange restrictions impede the introduction of new financial products.

MALAYSIA

Banking. Foreign banks face an unfavorable regulatory environment in Malaysia. New entry by foreign-owned banks is not permitted. In addition, established branches of foreign banks are being required to incorporate locally. No new commercial banking licenses, except those for offshore activities, have been issued since 1982. Foreign investment in existing banks is limited to only 10 percent for an individual and only 30 percent in aggregate. There is a prohibition on new foreign bank sub-branches and a prohibition on off-site ATM machines, as well as a limitation on the amount of lending by foreign banks to foreign controlled companies. These restrictions will continue to be imposed on foreign banks even after they change their legal status through local incorporation.

Securities. U.S. firms face substantial impediments in the Malaysian securities market. Foreign participation in Kuala Lumpur Stock Exchange members is limited to an aggregate total of 49 percent of the paid-up capital of an existing member firm, with each foreign participant limited to only a 10 percent share. Foreign brokers are restricted to a maximum 30 percent share ownership in an existing brokerage firm, although exceptions of up to 49 percent participation are possible. No new brokerage licenses are being issued. Although regulation is generally transparent, the financial authorities retain substantial discretion when approval is required for certain transactions.

PAKISTAN

Banking. Liberalization has improved the regulatory climate for foreign banks in Pakistan. In an important recent development, a U.S. bank received approval to expand its branch network throughout the country. Previously, foreign banks had been limited to a total of only four branches in Pakistan. In addition, foreign banks remain subject to higher withholding taxes than Pakistani banks. However, unlike their domestic counterparts, foreign banks do not have to comply with directed credit requirements.

Securities. Pakistan's securities market is not well developed. Securities brokers in Pakistan must be members of one of the country's three stock exchanges, but exchange members are restricted to Pakistani nationals only. Members of the stock exchange may form joint ventures with foreign firms, but foreign firms may hold only minority ownership. Joint ventures are treated the same as domestic brokers, but they are not allowed to participate in the mutual fund business.

PHILIPPINES

Banking. There has been significant progress in the treatment of foreign banks in the Philippines. In May 1994, new legislation removed the longstanding prohibition on entry by providing a five-year window during which ten wholly foreign-owned banks can establish full service branches. In addition, allowable foreign ownership in an existing Philippine bank was raised from 40 percent to 60 percent. Also, the operating environment for foreign banks was substantially enhanced. They will now be allowed to become universal banks and limitations on sub-branching were loosened.

Securities. Foreign securities firms are allowed to establish wholly-owned, domestically incorporated broker-dealers, but direct branches are still prohibited. Foreign firms may own only minority equity stakes in securities firms that are authorized to perform other securities activities in addition to brokerage and dealing. For firms that engage in trust activities and mutual fund management, the limitation on foreign ownership is 40 percent. Under recent liberalization of the banking laws, foreign banks will have the opportunity to establish bank subsidiaries with securities powers, including the ability to underwrite Philippine debt and equity issues. Once established, no distinction is made between wholly and partially-owned foreign firms and domestic firms.

SINGAPORE

Banking. There continue to be restrictions on entry and operations in the domestic retail banking market, although foreign banks face no barriers in the much larger offshore market. There have been some improvements in regulatory conditions. The permissible level of foreign ownership of local banks has been increased from 20 to 40 percent, but majority ownership is

still prohibited; foreign full-licensed banks were allowed to offer computer and telephone banking and to install terminals on the premises of corporate clients; and the overall lending limit to residents by offshore banks was raised from US$50 million to US$100 million. However, the freeze on the issuance of new domestic banking licenses continues. In addition, the prohibition on the establishment of new branches or off-premise ATMs by foreign banks remains in effect. Foreign banks continue to be leaders in the offshore banking market, where they account for more than half of all bank loans to resident non-banks.

Securities. Foreign securities firms have the same right to establish and offer financial services as do domestic securities firms with respect to government securities, unit trusts, merchant banking, and financial futures. Foreign securities firms are leaders in the futures market. However, Stock Exchange of Singapore (SES) regulations restrict foreign equity ownership of SES regular members to 49 percent. While international members of the SES can be 100 percent foreign-owned, they cannot vote in elections for the SES' Board of Directors, and they have limited input into SES policy decisions. No U.S. securities firm has elected to join the SES as an international member since that category was created in 1990. For transactions in Singapore dollar SES-quoted securities with residents, international members must trade in transactions of greater than S$5 million (about US$3.4 million). Licensed non-SES members or associates can trade in Singapore dollars SES-listed securities only through member firms.

TAIWAN

Banking. There have been a number of improvements in the treatment of foreign banks, but significant obstacles still remain. A ban on foreign investment in local banks was lifted in June 1994, but the individual investor limit was set at only 5 percent. In August, 1994, certain criteria for bank branch entry were eased and geographical and numerical restrictions on bank branching were eliminated. In addition, the waiting period for sub-branching was reduced from 5 to 2 years; however, this remains discriminatory because domestic banks are not subject to the same delay.

The activities of foreign bank branches continue to be restrained by the amount of local capital rather than the parent company's global capital. Access to local funding continues to pose a problem. Restrictions on the terms of foreign exchange liabilities and position-taking are important constraints that force foreign banks to rely heavily on the often illiquid interbank market. Foreign banks also are subject to limitations on guarantees of commercial paper that do no apply to their domestic competitors.

Securities. Before July 1993, only three foreign securities firms could establish branches (one each) in Taiwan. From July 1993 to February 1994, restrictions on branching in Taiwan were eased; foreign firms wishing to establish securities branches in Taiwan no longer have to be in the top ten in assets in their home country, and they no longer face discriminatory capital

requirements. In January 1994, all foreign ownership restrictions were abolished; U.S. firms may now create 100 percent-owned securities subsidiaries and participate freely in joint ventures.

Foreign and domestic firms are subject to the same capital requirements and, after establishment, may provide essentially the same securities services (including brokerage, dealing, underwriting, and securities financing). U.S. securities firms may provide brokerage services for local investors wanting to purchase shares listed in New York, London and Tokyo, while domestic firms may not.

Foreign institutional investors are subject to a US$200 millon individual investment limit and a US$7.5 billion aggregate investment limit. In addition, foreign institutional investors are subject to restrictions on repatriation of capital and earnings. Regarding listed shares of individual companies, foreign institutional investors are subject to a 5 percent per investor limit and an aggregate limit of 10 percent. Natural persons of foreign nations may not trade on the Taipei stock exchange or hold equity and debt instruments listed on the exchange. This eliminates a potentially large component of the prospective brokerage business of foreign firms.

THAILAND

Banking. New majority foreign-owned entry into the domestic Thai market is not possible, as no new on-shore (domestic) licenses have been granted since 1978. Thailand has issued new offshore banking licenses, but otherwise there has been little regulatory change and foreign banks continue to be subject to discriminatory treatment. Foreign banks are subject to a limit of only one branch and are not permitted to operate off-site ATMs. Although there is no longer a legal impediment to their joining the existing ATM network, in practice foreign banks have not been able to reach agreement with domestic banks on the conditions for membership. There also are strict limits on the use of expatriate personnel. Thailand has indicated that it intends to allow foreign banks with offshore licenses to open two offices outside of Bangkok, but the government has not yet set a date nor provided other important details.

Securities. Foreign firms are limited by law to a minority interest in brokerage firms. Foreign equity in finance/securities companies is limited to only 25 percent. Thai authorities intend to split finance and securities companies in the near future. When the division is complete, foreigners will be able to own 25 percent of finance companies and 49 percent of securities companies. Foreigners are limited to only 25 percent equity in domestic mutual funds. There are no restrictions on the post-establishment activities of firms with minority foreign interests.

AFRICA

EGYPT

Banking. Due to the large number of banks currently operating in Egypt, the Central Bank's policy regarding new entrants into the banking market, whether foreign or Egyptian, is very restrictive. No new banks have been licensed recently. However, there has been a significant improvement in the operating environment for foreign banks already established in Egypt. In 1993, foreign bank branches were allowed for the first time to operate in local currency and to engage in the same activities as Egyptian banks. Foreign banks do not face any constraints on their funding activities. They have access to the Central Bank discount window. Both foreign and Egyptian financial institutions comment on the lack of transparency in the banking laws and complain that their comments or recommendations are rarely taken into consideration.

Securities. Under the new Capital Market Law issued in 1992, foreign securities firms are provided free access to the Egyptian securities market and are allowed to participate in the same range of securities activities as domestic firms. However, with the exception of only two brokerage firms with American association, foreign securities firms are not active in the Egyptian market. Reluctance to enter stems from Egypt's current recession, lack of progress in the privatization process, and the generally underdeveloped state of Egypt's securities market. Bureaucratic red tape in establishment procedures is another impediment. Foreign firms are not allowed to manage local pension funds.

SOUTH AFRICA

Banking. There has been only limited foreign bank experience in South Africa in recent years and no U.S. bank is currently established in the country. Foreign banks (including U.S. banks) can enter the South African banking market through a subsidiary. Branch offices are allowed only if the foreign bank has a locally registered subsidiary. Locally registered foreign banks do not face funding constraints. They have equal access to the Reserve Bank discount window. A dual exchange rate system is in effect in the country, which raises the risks faced by foreign banks when bringing capital in from offshore.

Securities. Current law prohibits foreign nationals, individuals, or firms from undertaking securities market activities either directly or by establishing a locally incorporated subsidiary. The Johannesburg Stock Exchange has called for the removal of this prohibition, but legislative action does not appear to be imminent. Several foreign securities firms have "listening posts" or "nameplate" offices in South Africa. These are not registered, have no legal status, and may not conduct business. U.S. firms are active in providing underwriting services to South African residents issuing securities offshore.

EUROPE — OTHER THAN EU AND EFTA

CZECH REPUBLIC

Banking. The Czech Republic's liberal policy on issuing banking licenses has stimulated rapid growth of the banking sector. Foreign bank participation has been welcomed as an important part of the strategy to upgrade the banking sector and to help make domestic banking more competitive. Foreign banks are free to establish joint ventures, subsidiaries, branches, offshore branches, or representative offices. However, in mid-1994 the Czech National Bank (CNB) issued an informal "timeout" on the issuance of new banking licenses that applies equally to both foreign and domestic applicants. After establishment, foreign-owned banks may compete on an equal basis with domestic banks.

Securities. The Czech government places no restrictions on the establishment of foreign securities firms in the Republic. Foreign investors may purchase Czech equities though a broker on the Prague Stock Exchange or in the OTC market. The Czech government actively encourages foreign participation in the capital markets. Two U.S. securities firms are established in the Czech Republic, although most of the trading of U.S. institutional investors and hedge funds takes place through domestic firms.

HUNGARY

Banking. Hungary has a generally liberal banking environment and foreign banks do not face discrimination. However, foreign banks are required to operate as subsidiaries, not as branches. This means that they are not able to take advantage of their parent company's capital for lending and that they face other additional costs associated with maintaining a locally incorporated subsidiary. As in a number of countries, making the transition from a communist to a market-oriented system poses certain problems for foreign bank operations related more to an underdeveloped system than to discrimination.

Securities. Local incorporation is necessary in order to participate in either the stock or commodities exchanges. After establishment, foreign-owned firms are generally treated the same as domestic firms. As of September 30, 1994, no U.S. firm had actually established a securities subsidiary. Foreign purchasers of shares can exercise shareholder rights only if the shares are registered. Foreigners may not purchase state bonds unless a special license has been granted. Corporate equity or debt must be purchased with convertible currency.

POLAND

Banking. Foreign banks are subject to the same regulations as domestic banks. There are no special restrictions or constraints imposed on foreign banks with regard to the products they may

offer or in their funding activities. However, regulatory transparency, especially in the licensing process, is an area of continuing concern.

Recently, the National Bank of Poland (NBP) has expressed a desire for foreign banks to enter the Polish market by purchasing troubled Polish banks. The NPB has indicated that from a regulatory standpoint this would be the easiest way to enter because new licenses would not be required. The NBP also expressed it readiness to provide financial assistance with the problems of the acquired troubled bank. Although one foreign bank has entered Poland in branch form, the NBP has indicated that it will not approve any more branch applications.

Securities. The center of the Polish securities industry is the Warsaw Stock Exchange (WSE), which has been in operation since April, 1991. Few stocks have been issued on the WSE and a particular problem has been cited regarding a lack of transparency in underwriting procedures. Foreign securities firms may underwrite both debt and equity issues, deal in securities, and have seats on the Warsaw Stock Exchange. One U.S. bank is a primary dealer in Polish government securities. One United States mutual fund has established a Polish subsidiary.

RUSSIA

Banking. Foreign banks may enter the Russian banking market as a representative office, as a joint venture bank, as a minority holding in a Russian bank, or as a wholly-owned subsidiary. Russian banking law does not provide for entry via a branch. A two-year moratorium on foreign banks restricts newly licensed subsidiaries, as well as already licensed subsidiaries that had not started serving residents as of November 15, 1993, to serving nonresidents only.

Foreign banks in Russia also face other restrictions. There is a capital ceiling on foreign banks that limits their combined capital to no more than 12 percent of the aggregate capital in the Russian banking system. As of December 31, 1993, foreign banks' capital was well below this limit. In addition, the minimum capital required to establish a foreign-owned subsidiary is higher than that required for a domestic bank: $5.7 million versus $1.6 million.

Securities. The securities market in Russia is less than five years old and Russian authorities are still developing the policy direction in which they want the industry to go. A December 1991 regulation serves in lieu of a basic securities law.

With the exception of the limits facing foreign-owned banks described above, there is no apparent discrimination in the securities area. The Finance Ministry proposed a provision in its draft of the new securities law that would give broad latitude to regulators to impose discriminatory measures against foreign-owned securities firms, but the future of that particular draft is unclear.

Some U.S. firms are present as representative offices. One firm is fully licensed, which gives it the right to be a market maker, underwrite and place securities. No foreign-owned securities firms (except joint ventures) are official dealers for government securities, but there are no rules against these firms becoming dealers in this market.

TURKEY

Banking. There has been little change in the treatment of U.S. banks in Turkey. Foreign banks are not discriminated against under Turkish law. However, high minimum capital requirements deter initial establishment, especially since these are the same for branches and subsidiaries of foreign banks. The requirement that the capital must be maintained in Turkish lira also poses a sizable foreign exchange risk. In addition, lending limits are based on the branch's local capital rather than parent company's worldwide capital.

Securities. Foreign companies that wish to engage in securities trading locally must establish a subsidiary and must meet local capital requirements. Currently, the government is not issuing new licenses for either foreign or domestic securities firms. Both foreign and domestic securities firms can obtain whole or partial ownership of an existing securities company. Seats on the Istanbul Stock Exchange are open to all authorized securities dealers.

CANADA

BANKING

SUMMARY

Canada has a very extensive and deep banking industry. At the end of 1992, there were approximately 7,749 bank branches, giving Canada the highest ratio of full service bank branches to population of any industrial country. The sector continues to be dominated by the six largest "Schedule I" banks (widely held Canadian-owned institutions with capital in excess of C$750 million), which controlled over 90 percent of banking assets at the end of 1993.

There were 12 U.S. bank subsidiaries operating in Canada at end-1993, compared to 16 in 1990. The decline was due to bank mergers in the United States and to commercial decisions to withdraw from the Canadian market. U.S. banks in Canada tend to concentrate on the corporate sector, capital market transactions, and cross-border financial activities. They generally have not attempted to compete with Canadian financial institutions in the retail market.

Amendments to the Bank Act in 1992 removed some irritants of doing business in Canada for U.S. and other foreign banks, but their competitive positions are still disadvantaged by their inability to operate as branches and by a withholding tax on financing from their parents.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, establishes a comprehensive set of rules to govern trade and investment in financial services among the three signatory countries (U.S., Canada and Mexico). U.S. banks now enjoy a right of establishment and a guarantee of national treatment in Canada. NAFTA also established a Financial Services Committee to supervise implementation of the chapter and deal with any banking issues that arise between the two countries. If differences of interpretation cannot be resolved by this committee, the NAFTA parties can take the issue to a dispute settlement mechanism. Not all issues of concern to U.S. banks were resolved in the negotiation of the NAFTA. For example, NAFTA provides that the host government can require that financial firms establish as subsidiaries rather than as branches. The matter of form of establishment will be reviewed in the future.

DESCRIPTION OF THE MARKET

Commercial Banks

At the end of 1993, there were 65 banks with licenses to operate in Canada, but the banking sector was dominated by the six largest "Schedule I" banks. In descending asset size, these banks are the Royal Bank of Canada, Canadian Imperial Bank of Commerce (CIBC), Bank of Montreal, Bank of Nova Scotia (Scotiabank), Toronto Dominion Bank, and National Bank of

Canada. These institutions accounted for 90 percent of total banking system assets at the end of 1993. The remaining 59 banks are Schedule II banks (closely held institutions with capital not exceeding C$750 million). The Schedule II banks include 54 foreign bank subsidiaries, of which 12 are U.S. bank subsidiaries.

Balance Sheets for the Canadian Banking System
(C$ billions, year-end)

	Shareholders Equity	Liabilities	Assets
		1990	
All Banks	31.3	577.8	609.1
Domestic Banks	27.2	522.9	550.1
Foreign Banks	4.1	55.0	59.1
(U.S. Banks)	1.3	12.1	13.5
		1993	
All Banks	39.2	716.8	756.0
Domestic Banks	35.4	659.7	695.2
Foreign Banks	3.8	57.0	60.8
(U.S. Banks)	1.1	11.1	12.2

Source: Chartered Bank Assets & Liabilities, Supplement to the Canada Gazette, Part 1.

Bank assets increased by 24 percent over the period 1990-93, but this asset growth was almost exclusively due to the activity of domestic banks, including their acquisition of trust companies. The assets of foreign banks increased by only 3 percent, while U.S. bank assets declined by 9.6 percent.

The period 1990-93 was characterized by declining interest rates, and in this environment banks found it possible to reduce interest rates on deposits faster than on loans, and consequently interest margins were quite favorable. (For the bank fiscal year ended October 31, 1993, the six largest Canadian banks had an average interest rate spread of 3.34 percent, virtually unchanged from the previous year.) On the other hand, the economic recession and slow economic growth that also prevailed throughout this period meant that loan demand was weak and banks were forced to increase the portion of relatively lower yielding bonds in their asset portfolio.

Bank financial performance was also negatively affected by continued write-downs and write-offs of real estate lending as Canadian real estate markets (particularly Ontario commercial real estate) remained depressed. In addition, Canadian banks (and at least one U.S. bank in Canada)

were affected by the failure of international property developer Olympia and York. Canadian banks had either sold or completely written-off their LDC lending portfolios by the early 1990s. Nevertheless, the six largest Canadian banks recorded net income of C$2.9 billion in their last fiscal year, an increase of more than 50 percent over the previous year. Return on common shareholders' equity increased to 9 percent from 5.5 percent the previous year. Canadian banks have strong equity positions and already meet the Bank for International Settlements Tier I and Tier II capital standards.

Banks in Canada are federally chartered and regulated and may operate in all 10 Canadian provinces and two territories, as well as overseas. At the end of 1992, there were approximately 7,749 bank branches throughout Canada (and Canadian banks had 261 more branches in 56 foreign countries), giving Canada the highest ratio of full service bank branches to population of any industrial country. The Schedule I banks had more than 170,000 employees at the end of 1992. Schedule II banks had 564 branches in Canada. NAFTA-country Schedule II banks can set up branches the same as Schedule I banks. Non-NAFTA country Schedule II banks have to secure approval from the Minister of Finance. There is no differentiation in retail and non-retail Schedule II branching. Most Schedule II bank branches are located in Ontario, Quebec, and Vancouver. Generally, there are not any differences/limitations in powers between Schedule I and Schedule II banks.

Canadian banks can engage in a wide range of financial activities in addition to traditional banking services. A bank may also provide financial services (including financial planning), investment counselling and portfolio management services, and promote merchandise and services to payment, credit and charge card holders. In addition, a bank may create subsidiaries to undertake other financial activities, including dealing in securities, mortgage lending, trust services, insurance, managing and selling mutual funds, merchant banking, venture capital, real estate investment and brokerage, leasing (except automobile leasing) and factoring.

"Near Banks"

A number of near-banks in Canada compete for the deposits and business of the banks. These include the trust and loan companies (similar to U.S. savings and loan institutions), credit unions (including the important Caisses Populaires in Quebec), sales finance companies, and several public sector savings and financial agencies (Canada Mortgage and Housing Corporation — a federal mortgage company; Export Development Corporation — a federal export lending agency; various provincial savings banks; and the federal Farm Credit Corporation.). Other financial institutions include consumer loan companies, life and health insurance companies, property and casualty insurance companies, investment dealers, and merchant banks.

Foreign Banks

Foreign banks were not authorized to operate in Canada until 1980. At that time, foreign banks

were permitted, but only as separately organized and capitalized subsidiaries, not as branches. Foreign banks generally concentrate on wholesale banking, capital markets, and corporate lending. Hongkong Bank of Canada is an exception. It is the largest Schedule II bank (and the seventh largest bank in Canada in terms of assets), and is the only Schedule II bank with an extensive retail branch network. Hongkong Bank's growth is a function of its acquisition of several other institutions and its cultivation of Canada's rapidly growing Chinese community.

Supervision

Banks are regulated by the Office of the Superintendent of Financial Institutions (OSFI), which also regulates federally chartered trust and loan companies and insurance companies. OSFI is an independent regulatory agency within the federal government structure. The Superintendent is appointed by the Finance Minister and confirmed by the Cabinet for a seven-year term. On matters requiring the attention of the Cabinet, the Finance Minister represents OSFI. Federal government policy regarding financial institutions is determined by the Finance Department.

Banks are required to join the Canadian Deposit Insurance Corporation (CDIC), a federal entity (Crown Corporation) that insures depositors up to C$60,000. Banks and trust and loan companies currently pay a CDIC insurance premium rated at 0.167 percent of assets. Due to several failures of insured institutions since the mid-1980s, the CDIC had a cumulative deficit of C$1.5 billion at the end of 1993, including a record C$861 million loss in 1992. A number of Schedule II banks (including some U.S. banks) that do not accept retail deposits have raised questions about if or how they should participate in the CDIC scheme, which is oriented toward the protection of retail depositors.

Since 1987, banks have been allowed to own securities firms, and each of the six largest Schedule I banks has either acquired a securities firm since then or started one up de novo. Consequently, bank-owned securities firms dominate the Canadian securities market although there are still several large independent securities firms.

The Bank Act, along with the Trust and Loan Companies Act, Insurance Companies Act and Cooperative Credit Associations Act, were revised in June 1992. The revised Bank Act grants banks the right to own trust and loan companies and insurance companies. Banks were also authorized to set up "networking" arrangements with other financial institutions and distribute those institutions' products and services in their bank branches to their own customers. Banks gained the right to own "specialized financing corporations," which allows them to undertake broader venture capital and merchant banking activities than were permitted under previous legislation. Banks were permitted to offer investment counselling and portfolio management services directly rather than through securities subsidiaries, and financial planning services have also been recognized as part of the business of banking. In addition, banks may offer real estate services (property ownership, development, management and brokerage), and they were allowed to offer nonfinancial services such as information management.

Movement into the trust area by banks has been significant so far, aided by the acquisition of two large trust and mortgage companies by Schedule I banks (one of which was undertaken with major financial assistance from the CDIC). A Schedule I bank merged with a major trust company and another Schedule I bank started a trust company subsidiary de novo. Movement by banks into the insurance area, however, has been cautious so far, with banks making only small acquisitions and/or starting subsidiaries offering only a limited line of insurance products. The limited insurance activities is largely due to a restriction on the banks ability to network most traditional insurance products.

Clearing in the Canadian banking system is transacted through the Canadian Payments Association (CPA), created by the Canadian Payments Association Act. The CPA is chaired by the Bank of Canada, the central bank, and has representatives of the major direct clearing institutions (the largest banks and trust companies) on its board of directors. The Bank of Canada, unlike the U.S. Federal Reserve System, does not have a direct role in the clearing process. The limited number of financial institutions in Canada (there are currently 14 direct clearing and 140 indirect clearing members of the CPA) reduces the complexity of the clearing process compared to the United States, but the CPA still cleared 2.2 billion transactions valued at C$18.4 trillion in its last fiscal year.

Canada has an extensive network of automatic teller machines (ATMs) accessible by depositors in banks, trust companies, and credit unions. There are now approximately 12,000 bank-owned ATM machines in Canada, a number that has doubled over the last four years. The dominant ATM network is a Canadian-owned system, Interac. Some ATMs also allow access to the U.S. Cirrus and Plus ATM networks. The CPA requires that transactions between member institutions in Canada on any of the three ATM networks be routed and settled entirely within Canada.

U.S. PRESENCE IN THE MARKET

There were 12 U.S. bank subsidiaries in Canada at the end of 1993, four fewer than at the end of 1990, but still more than from any other country. The decline in the number of U.S. banks in Canada is due both to the merger of U.S. parent banks and to independent decisions by the U.S. parent banks to withdraw from the Canadian market. U.S. banks had C$12.2 billion in total assets at the end of 1993, down from C$13.5 billion at the end of 1990. U.S. banks accounted for 1.6 percent of banking assets and 1.3 percent of loans at the end of 1993, compared to 2.2 percent and 2.1 percent, respectively, at the end of 1990. Two U.S. banks ranked among the top 10 foreign banks at the end of 1993; one was the second largest and the other was the sixth largest.

U.S. banks in Canada concentrate on the corporate sector and capital market activities and have not attempted to compete with Canadian financial institutions for the retail market. Only two

U.S. banks have retail branches in more than one Canadian city. Given their small capital base relative to much larger Canadian competitors, successful U.S. banks in Canada have emphasized their expertise in capital markets activity, specific off-balance sheet areas such as foreign exchange swaps, and financial activities where the U.S. bank can serve a client on both sides of the border. Among the non-lending activities currently engaged in by U.S. banks in Canada are cash management, investment banking, Government of Canada bond placement and trading, credit cards, factoring, and trading in derivative products (including market making).

No U.S. bank has chosen so far to open a traditional trust company subsidiary as permitted by the new Bank Act, although at least one bank is considering doing so. Prior to the new Bank Act, another U.S. bank entered into a joint venture with a Canadian trust company to form a limited-purpose trust company. This trust company engages only in stock transfer and corporate trust services; it does not accept deposits.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Until 1980, foreign banks were not permitted to operate in Canada except as representative offices. An amendment to the Bank Act in that year permitted the establishment of foreign bank subsidiaries, but foreign banks were subjected to administrative controls on their growth via limited allocation of "deemed authorized capital" and market share limits. The U.S.— Canada Free Trade Agreement (FTA), which entered into force January 1, 1989, exempted U.S. banks from the system of deemed authorized capital and market share limits. They also were exempted from the requirement to obtain approval from the Finance Minister prior to opening branches of their subsidiary banks throughout Canada and from regulatory restraints on transfers of loans to their parents, and all U.S. investors were exempted from the 25 percent limit on aggregate foreign ownership of widely held (Schedule I) Canadian banks.

U.S. and other foreign banks are still prohibited from operating in Canada through a branch, which puts these banks at a competitive disadvantage compared to their Canadian competitors. The major problem resulting from having to operate as a subsidiary, rather than as a branch, is that U.S. and foreign banks are precluded from competing for large corporate loans, as they are proscribed from extending loans to a single borrower in excess of 100 percent of the subsidiary's capital, and cannot take advantage of their parent bank's capital. In addition, subsidiaries are only expected to reach the 100 percent limit in exceptional cases, and must notify OSFI when they exceed the 50 percent level. Another disadvantage of operating as a subsidiary is the added expense and complication of maintaining a separate board of directors, half of whom must be Canadian residents.

U.S. and other foreign banks are also disadvantaged by Canada's Income Tax Act, which places a nonresident withholding tax on funds borrowed by the foreign bank subsidiary from its nonresident parent bank and nonresident related companies. This tax provision makes it

uneconomical for foreign bank subsidiaries in Canada to borrow from their parent banks to lower their funding costs, which would allow them to be more competitive and improve their liquidity. There is no relative differential in funding costs between Schedule I and Schedule II banks. The withholding tax adds to the funding disadvantage initially resulting from the lack of a large retail branch network to attract low-cost funds. The differential exists between nonresident foreign bank subsidiaries and domestic banks.

The Bank Act revision did, however, loosen the previous requirement that banks maintain and process all their customer data in Canada. Banks must request approval from OSFI for offshore data processing, but reportedly all requests by U.S. banks have been approved. There is still a prohibition precluding banks from offering data processing services to outside parties. However, an exemption from the order can be requested. All banks (both Schedule I and Schedule II) need to apply to the federal OSFI for an exemption. To date, no U.S. bank that has applied for an exemption order has been turned down. The new Bank Act also allowed foreign bank subsidiaries in Canada to use the same fiscal year as their parents; previously the subsidiaries had to meet a fiscal year-end specified in the act, which often required the expense of an additional set of audited financial statements. Finally, since 1989 three U.S. banks have been authorized by the Finance Department to function as primary distributors of Canadian government securities. One U.S. bank is the second-largest player in the government bond market in Canada.

FINANCIAL MARKET DISCUSSIONS

The North American Free Trade Agreement (NAFTA), which went into effect January 1, 1994, among the U.S., Canada and Mexico, contains a provision that potentially addresses U.S. concerns over the establishment of U.S. banks in Canada. NAFTA Article 1403 states, "... [At] such time as the United States permits commercial banks of another Party located in its territory to expand through subsidiaries or direct branches into substantially all of the United States market, the Parties shall review and assess market access provided by each Party in relation to the principles of paragraphs 1 and 2" (regarding the establishment of financial institutions).

The NAFTA also established a Financial Services Committee, which meets at least annually to assess the functioning of the NAFTA as it applies to financial services. This committee also has the authority to supervise the implementation of the NAFTA Financial Services Chapter, consider issues regarding financial services that are referred to it by a NAFTA party, and participate in dispute settlement procedures.

Exchange Rates

Average 1990:	CS$ = US$0.8571
Average 1991:	CS$ = US$0.8728
Average 1992:	CS$ = US$0.8276
Average 1993:	CS$ = US$0.7753

CANADA

SECURITIES

SUMMARY

Canada has a well-developed capital market in which a full range of financial services and securities products are available. Financial activity in the province of Ontario accounts for about 80 percent of all fixed income and stock market transactions. Regulation of the markets is carried out primarily by provincial authorities and self-regulatory organizations. The federal government plays a limited regulatory role, principally limited to regulating federal government debt.

Canadian securities firms dominate the markets for brokering and underwriting. The largest securities firms are owned by Canada's largest banks. U.S. securities firms have not developed their operations in Canada beyond peripheral market segments and small market niches. This is the consequence of past discrimination against foreign owned firms, market structure, and, apparently, general corporate strategies that do not give priority to establishing in Canada.

Entry by subsidiary rather than by branch continues to be required. Banks may own securities affiliates, and ownership up to the 100 percent level is permitted. There are a variety of different types of activities that securities firms may engage in, often requiring multiple dealer registration requirements.

Recently, the Ontario Securities Commission confirmed that residency is not a requirement to manage a publicly offered mutual fund in the province of Ontario. In addition, nonresident foreign dealers are now permitted to participate in the interdealer market for Government of Canada bonds, provided they are members of an accepted foreign SRO and pay fees to the Investment Dealers Association and to the Canadian Investors Protection Fund as if they were members of IDA.

The financial services chapter of the NAFTA, which entered into force on January 1, 1994, establishes a comprehensive set of rules that govern trade and investment in financial services among the three signatory countries (U.S., Canada, and Mexico). U.S. securities firms did not benefit from the financial services provisions of the U.S.— Canada Free Trade Agreement (FTA.) The regulation of securities firms in Canada is largely done at the provincial level. As the FTA covered only federal measures, the activities of securities firms were not protected. This has been altered by NAFTA, which covers state and provincial measures as well as federal measures. Thus, U.S. securities firms benefit from the provisions of chapter 14 (Financial Services) of NAFTA. The U.S. firms have a clear right of establishment and a guarantee of national treatment in Canada. This chapter, which is summarized in the chapter on NAFTA, also provides for consultations between the governments and a dispute settlement mechanism.

DESCRIPTION OF THE MARKET

Canada has a well-developed capital market offering a wide range of traditional debt and equity instruments, as well as more innovative financial products, including futures and derivatives trading. With the exception of certain constraints on cross-border activities (discussed below), foreign securities firms can participate freely in these markets.

Market activity, particularly at the retail level, is dominated by several large Canadian securities firms. It is estimated that the eight largest Canadian firms account for slightly over 50 percent of the regulatory capital of the securities sector, and that they typically earn about two-thirds of the sector's total revenue. This domination partly reflects past policies of discrimination against foreign securities firms, and the fact that most of Canada's major investment dealers are owned by Canada's largest banks.

In 1971, the Province of Ontario adopted legislation prohibiting the entry of foreign securities firms. The 26 existing foreign firms were grandfathered, but in 1974 they were subjected to constraints on their growth. By 1985, most of the grandfathered firms had opted to leave Canada. Only in 1987 were the rules changed and foreign firms began returning to the Canadian securities market.

Major Full-Service Securities Firms in Canada

Firm	Parent
RBC Dominion Securities	Royal Bank of Canada
Wood Gundy Inc.	Can. Imperial Bank of Commerce
ScotiaMcLeod	Bank of Nova Scotia
Nesbitt Burns	Bank of Montreal
T-D Securities, Inc.	Toronto-Dominion Bank
Levesque, Beaubien	National Bank
First Marathon Securities Ltd.	Independent
Midland Walwyn Capital	Independent
Richardson Greenshields	Independent
Gordon Capital Corporation	Independent

Canadian Capital Market Activity
(Net New Issues Placed in Canada and Abroad, C$ Billions)

	1990	1991	1992	1993
Bonds				
Federal Government	7.0	19.5	13.1	22.1
Provincial Governments	9.9	28.9	23.3	29.7
Corporations	1.1	2.4	1.3	1.2
Common & Preferred Stocks	5.9	10.7	11.4	18.4
Short-Term Paper				
Federal Government	15.2	11.1	12.8	12.1
Provinces, Prov. Crown Corps., & Municipalities	1.7	2.2	-0.2	3.7
Commercial Paper	1.9	0.8	-0.6	1.0
Bankers' Acceptances	0.4	-8.0	-14.2	5.5

Stock Exchanges

The principal securities exchanges in Canada are the Toronto Stock Exchange (TSE), the Montreal Exchange (ME), the Vancouver Stock Exchange (VSE) and the Alberta (Calgary) Stock Exchange (ASE). Most securities activity in Canada occurs in Toronto, which is Canada's industrial and financial capital. In 1993, the Ontario market accounted for at least one-half of new public offerings in Canada, approximately 80 percent of listed trading value, and up to 80 percent of money market and stock market transactions. All of Canada's largest securities firms have their headquarters in Toronto. All but a few of the registered investment dealers in Canada are active in Ontario.

The Toronto Exchange was the second most active exchange in North America in 1993 in terms of trading value, after the New York Stock Exchange. Included among the TSE's 88 members at the end of 1993 were five subsidiaries of U.S. firms. The Toronto Futures Exchange is a legally distinct institution, although it is administered by TSE staff and shares the TSE trading floor.

The importance of the Montreal Exchange has tended to fade in recent decades as Canada's economic center of gravity has shifted to Toronto. Political uncertainty in Quebec also has resulted in a transfer of listings and financings, mainly to the TSE. The Quebec provincial

government has sought to stem the exodus via new tax incentives for investing in new share issues listed on the ME, and through the use of the province's Caisse de Depot, which invests heavily on the ME using provincial pension fund assets. The ME also has introduced new financial products, including options trading and a futures contract for Canadian government federal bonds.

The Vancouver and Alberta exchanges tend to serve small resource-based companies. The VSE is a self-styled venture capital market. It has been criticized in the past for allowing highly speculative activity. In 1994 an independent commission recommended that provincial oversight of the VSE needed to be strengthened. In October 1994, the British Columbia government announced proposed measures that would give added clout to the BC Securities Commission. The proposals include giving the BCSC the authority to make legally binding rules, the organization of a fraud office, and the ability of investors to launch "class action" lawsuits to recover losses caused by manipulation or misleading disclosures. Trading volumes on the VSE and ASE are quite high, but since most of the issues traded are "penny stocks," trading value is relatively low.

Canada's over-the-counter stock market is managed by the Canadian Dealing Network (CDN), which is affiliated with the TSE. It was established in 1991 to assume operation of the over-the-counter market from the Ontario Securities Commission. More than 1 billion shares were traded in 1993, double the level of 1992. Over 400 stocks are quoted on the CDN.

Market Indicators

As measured by the TSE 300 Index, stock prices declined from 1990 until early 1993, a consequence of slack domestic economic activity. Prices then recovered sharply as some industrial sectors began to rebound, and in response to declining bond yields that made it more attractive to place investable funds into equity markets. Mutual fund assets almost doubled in value in 1993. As a result of improving stock market and economic conditions, 1993 saw record new equity offerings.

Bond market activity also was strong, especially since a major deterioration of federal and provincial finances began in 1991. However, corporate bond placement was level as corporations increasingly tapped the equity market for their financing needs.

Canadian Stock Market Indicators				
	1990	1991	1992	1993
TSE-300 Price Index (End of Year)	3,256.8	3,512.4	3,350.4	4,321.4
ME-25 Price Index (End of Year)	1,726.1	1,860.4	1,771.1	2,062.7
Value of Shares (TSE+ME, C$ billions)	5.3	6.8	8.6	16.7
Volume of Shares (TSE+ME, Millions of Shares)	503.9	596.4	1,001.8	1,492.5
Mutual Funds Assets (End of Year, C$ billions)	24.9	49.9	67.3	114.6

Secondary Market Trading, Domestic Market (C$ Billions)				
Bond Markets	631	942	1,037	1,275
Money Markets	1,217	1,340	1,517	1,520
Equity Markets	84	90	102	186

Regulation

The regulation of the securities industry in Canada is primarily at the provincial level. Each of Canada's 10 provinces (and two territories) has a securities act and a securities commission or equivalent regulatory authority to enforce the act, implement the regulations, and supervise the industry. The most important securities commissions in Canada are located in the provinces with the largest economies and most active securities exchanges: the Ontario Securities Commission, the Quebec Securities Commission, the British Columbia Securities Commission, and the Alberta Securities Commission. Each is structured along the lines of the U.S. Securities and Exchange Commission (SEC). The chairmen of the provincial securities commissions are appointed by provincial governments and serve on a board with other commissioners. The provincial securities commissions have formed an organization, the Canadian Securities Administrators, to coordinate and harmonize regulations.

The Ontario Securities Act requires that any person or company that trades a security or acts as an underwriter or advisor must register with the Ontario Securities Commission (OSC).

Registered dealers are classified in one or more of the following categories: Broker, Mutual Fund Dealer, Scholarship Plan Dealer, International Dealer, Investment Dealer, Limited Market Dealer, and Securities Dealer. Even with universal registration, there is no system for monitoring and regulating registrants that engage only in exempt market business and conduct their business through a registrant category that is not regulated at this time, e.g., limited market dealer, international dealer. The largest domestic and foreign firms usually register in one or more categories. International dealers are permitted to operate in Ontario from "offshore" and are permitted to trade on Ontario's bond market broker screens. Brokers are required to become a member of the Toronto Stock Exchange, and investment dealers are required to be members of the Investment Dealers Association (see below).

The OSC, the QSC (Quebec Securities Commission), and the BCSC (British Columbia Securities Commissions) cooperate with the SEC on enforcement matters. The two agencies agreed to a Multi-Jurisdictional Disclosure System (MJDS) in 1991. Under the MJDS, securities issuers can file an approved prospectus in either of the jurisdictions and sell securities in both jurisdictions. The MJDS is used extensively by Canadian issuers; from its implementation through September 30, 1994, 61 Canadian issuers have made 86 offerings through the MJDS. Only two U.S. issuers have taken advantage of the MJDS to offer securities in Ontario. The much greater size of the U.S. financial market is the most likely explanation for this disparity in issuance activity.

Self-Regulatory Organizations

Two main groups of self-regulatory organizations (SROs) also regulate the industry; a total of 144 firms are regulated by these SROs. The Investment Dealers Association (IDA) is a nationwide trade group combining the trade association aspects of the U.S. Securities Industry Association with the U.S. National Association of Securities Dealers' regulation of members. The IDA is informally recognized by the provincial securities commissions for purposes of member regulation. The stock exchanges, particularly the TSE, the ME, the VSE and the ASE, also are recognized as SROs for the purposes of regulating member firms, listed companies and trading. The IDA and several of the exchanges are currently in the process of reorganizing the SRO member regulation function.

The Investment Funds Institute of Canada (IFIC) is the industry association for firms engaged in the mutual funds business. It is not an SRO. It promotes professionalism and favorable business practices through a large training program, and it monitors trends and developments in the mutual funds sector. It does not develop or enforce its own regulations, nor does it deal directly on behalf of its members with the predominantly provincial regulators responsible for mutual fund companies and activities.

The Canadian Investors Protection Fund (CIPF), sponsored by the members of the SROs, serves to limit exposure of dealer clients to dealer failure. Securities firms are required by law to segregate fully-paid securities kept on behalf of customers from their own. This largely isolates

their clients from financial difficulties experienced by CIPF members. The CIPF can draw on cash resources raised by assessments on members as well as on a bank line of credit. All SRO members, even those with no retail business, must pay CIPF assessments. Customer accounts are covered up to C$500,000, of which no more than $60,000 can be in cash.

Federal Government Role

The federal government, in particular the Finance Department, has a secondary role in supervising the securities industry. It is responsible for the regulation of its own debt market. The Bank of Canada acts as the government's fiscal agent and appoints the primary distributors of federal debt, who are similar to, but not identical to, primary dealers in the United States. Recently, federal and provincial governments have discussed harmonization of regulations or the creation of a national securities regulator. Provinces, most prominently British Columbia and Quebec, have been uninterested thus far in ceding regulatory power. Ontario has not taken a position.

A memorandum of understanding (known as the Hockin-Kwinter Accord) between the Ontario provincial minister of financial institutions and the federal minister of finance identifies those activities that may be carried out directly by a federally chartered institution, and those that must be carried out by a provincially regulated securities subsidiary. However, the terms of Hockin-Kwinter are not applicable with respect to other provinces.

U.S. PRESENCE IN THE MARKET

U.S. securities firms are present in important but limited sectors of the Canadian securities industry. This is the result of restrictions previously placed on the operations of U.S. securities firms in Canada, which resulted in many of those firms grandfathered under the 1971 law to exit the Canadian market by 1985. Only recently have the firms begun returning to Canada. Presently, out of a total of 111 firms registered with the IDA, 24 are foreign, of which, 10 are U.S.-based.

U.S securities firms tend to shun retail activity. But subsidiaries of U.S. firms are quite active in the wholesale markets. Several U.S. securities firms are major players in certain market segments. U.S. firms are particularly active in the fixed income market. Six U.S. firms are primary dealers for Government of Canada debt, and another is a major underwriter for Provincial and Provincial Crown corporation debt.

The activity of U.S. securities firms is concentrated in Ontario. It is difficult to judge the market share of U.S. securities firms in Ontario, although a considerable part of all securities activity in the province may be carried on by U.S. firms registered with the OSC as International

Dealers; these firms are not required to establish an office in Ontario.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In 1987, the Province of Ontario changed its law to permit not only the entry of foreign securities firms, but also the ownership of securities firms by banks. These changes took place in mid-1987, and were followed by federal legislation. However, Canadian firms were given a head start regarding entry through acquisition of existing investment dealers because they were allowed to initially acquire up to 100 percent of a dealer in June 1987 whereas nonresidents could acquire only up to 50 percent. Foreigners were not allowed to acquire a full ownership (through acquisition) until after June 1988. However, they were allowed to establish wholly-owned subsidiaries from the beginning.

The Financial Services chapter of the NAFTA gives U.S. securities firms a right of establishment and guarantees them national treatment. The firms also benefit from rules regarding most-favored-nation treatment, the right to introduce new products, access to membership in self-regulatory organizations, and transparency of regulation. The provisions of this chapter of NAFTA are summarized elsewhere in this report.

One special provision of the chapter merits comment here. Canada has excluded the securities industry from the obligation not to introduce measures that restrict the cross-border sale of services that a country allowed on the date of entry into force of the NAFTA. The reason for this exclusion is that Canada believes that its securities market is more open to cross-border participants than the U.S. securities market. Therefore, it was unwilling to commit to a standstill on restrictive measures unless the U.S. was willing to extend a benefit to the Canadian securities industry. The two governments were unable to reach an agreement on an appropriate exchange of commitments. The U.S. regretted that Canada thought it necessary to take a reservation to this obligation, but believed it appropriate to take a similar reservation.

Two specific issues have confronted U.S. securities dealers recently, but both have been resolved satisfactorily. First, access to the interdealer bond broker system for Government of Canada bonds by offshore dealers was a point of dispute between some U.S. firms and the IDA. IDA bylaws require that no member of the IDA may trade Canadian dollar-denominated securities issued or primarily traded in the Canadian markets through the facilities of an interdealer bond broker unless that broker has been approved by the IDA. The IDA initially insisted that all participants in these transactions be IDA members. After lengthy discussions with U.S. firms, a compromise was reached whereby foreign dealers may participate in these transactions provided that they are members of an accepted foreign SRO and pay fees to IDA and to the CIPF as if they were IDA members.

Second, the U.S. investment company industry cited restrictions on the extent to which a U.S.

investment adviser could provide investment services in Ontario without establishing a business presence in the province. The U.S. industry argued that the Ontario Securities Commission applied a de facto residency requirement in order to manage a publicly offered Canadian mutual fund, which was in contrast to the favorable access accorded foreign advisers to provide comparable services in the U.S. market. The issue was resolved by an OSC press release of August 30, 1994, which stated that the permitted activities of nonresident registered advisers meeting certain terms and conditions will be the same as the scope of permitted activities of Ontario registered advisers resident in Canada.

FINANCIAL MARKET DISCUSSIONS

The North American Free Trade Agreement (NAFTA), which went into effect January 1, 1994, among the U.S., Canada, and Mexico, established a Financial Services Committee, which meets at least annually to assess the functioning of the NAFTA as it applies to financial services. This committee also has the authority to supervise the implementation of the NAFTA Financial Services Chapter, consider issues regarding financial services that are referred to it by a NAFTA party, and participate in dispute settlement procedures. (See NAFTA chapter for additional details.)

Exchange Rates

Average 1990:	CS$ = US$0.8571
Average 1991:	CS$ = US$0.8728
Average 1992:	CS$ = US$0.8276
Average 1993:	CS$ = US$0.7753

MEXICO

BANKING

SUMMARY

The implementation of the North American Free Trade Agreement (NAFTA) on January 1, 1994, marked the start of a process that, over time, should level the playing field for U.S. and Canadian investors in the Mexican banking industry. Through wholly-owned subsidiaries, U.S. and Canadian investors may engage in the full range of activities permitted by their Mexican counterparts, with certain minor, negotiated exceptions. Initially, there will be limitations placed on the maximum market share of U.S. and Canadian institutions. However, these limitations will be phased out by the year 2000. Additionally, under NAFTA, U.S.- or Canadian-based financial institution subsidiaries of foreign banks may also establish bank subsidiaries in Mexico. These non-NAFTA entrants will be subject to the same licensing and operating requirements as U.S. or Canadian subsidiaries. This represents a dramatic change from Mexico's past restrictive policies. On October 17, 1994, the Finance Ministry announced that 18 licenses to establish banks were being granted. Ten of these are to U.S.-owned institutions.

The U.S. and Mexican financial systems remain at different levels of development. The full range of activities available to banks and securities firms in the United States is not yet available in Mexico, either to Mexican-owned or foreign-owned firms. By guaranteeing national treatment to U.S. and Canadian firms, NAFTA establishes a framework for ensuring the equitable treatment of Mexican and foreign institutions as the Mexican financial system develops.

Mexico's banking system has undergone, and continues to undergo, a significant transformation. In 1982, the country nationalized the banking system, with only the exceptions of Citibank and Banco Obrero. In 1991 and 1992, Mexico's commercial banks were sold back to investors for $12.4 billion equivalent. This not only reversed the nationalization, it also marked the end of a consolidation trend that had begun in the 1970s. With the licensing of 14 new banks between June 1993 and March 1994, the total number of banks in Mexico grew to 34. The government predicted that, by year-end 1994, approximately 60 Mexican and foreign-owned banks would be authorized.

The system is heavily concentrated, with the three largest commercial banks holding a total of 50 percent of all assets, 53 percent of all loans, and 59 percent of commercial banking system capital, as of December 31, 1993. Citibank, with six branches, was the only foreign bank operating in Mexico, with total assets representing approximately 1.4 percent of the market. An additional 23 U.S. banks maintained representative offices. With Mexico's recent liberalization in policy, Citibank as well as other U.S. institutions have applied for permission to establish subsidiaries in Mexico.

As of March 1994, six Mexican banks had a presence in the United States, through 12 state-

licensed agencies and majority ownership in two U.S. banks (total assets $4.0 billion equivalent). Additionally, five Mexican banks had U.S. representative offices.

The deregulation and legal reforms that followed the privatization of Mexican banking have provided greater operating flexibility for banks, while imposing stricter prudential regulation.

DESCRIPTION OF THE MARKET

The foundation of Mexico's banking system was laid in the 1920s with the establishment of the National Banking Commission (1924), the passage of the Banking Law (1924), and the creation of a central bank, the Bank of Mexico, (1925).

The Ministry of Finance is the principal regulator of the banking system. It issues licenses and sets general credit and fiscal policies. The Bank of Mexico implements Ministry of Finance policies and operates interbank check clearing and compensation systems. The National Banking Commission is responsible for supervision and vigilance. The commission was recently restructured in order to improve its capabilities, and permanent supervisory teams have been installed in the largest banks.

Commercial Banks

Until the banking rules were changed in 1975, banks were required to specialize as deposit banks, savings banks, financial societies, mortgage banks, trusts, capital societies, or savings and loans. Affiliations were permitted among certain institutions, leading to the formation of limited banking groups. The 1975 banking reform allowed banks to offer all these financial services under one roof, which Mexico terms "multiple banking." In 1978, the first multiple bank began to operate.

Mexico's commercial banks, with the exception of Citibank and Banco Obrero, were nationalized in 1982. The banks were sold back to private investors in 1991 and 1992 for 38.6 trillion pesos (approximately $12.4 billion). The Mexican government retained a minority interest in three banks, but in early 1994 announced that it would sell its remaining holdings.

The buyers of the privatized banks paid a comparatively high price for their acquisition, on average over three times book value. This premium reflects the high profitability of Mexican commercial banks — a shortage of credit and lack of competition has allowed banks to generate high margins. The net interest margin for banks overall rose from 5.91 percent in December 1991 to 6.87 percent in December 1993. The need to cover the cost of nonperforming loans and to increase capital has encouraged banks to maintain wide spreads. However, increased competition from new Mexican banks and from foreign banks is expected to force these spreads

to narrow.

Prudential regulation has been enhanced and bank capital requirements raised. The required level of capitalization for banks (net capital as a percentage of risk-based assets) was gradually increased from 4 percent to 8 percent between 1988 and 1993. As of December 1993, the percentage of net capital to risk-weighted assets among commercial banks was 9.93, up from 7.64 at the end of 1991. Concerned about foreign borrowing, in April 1992 the Bank of Mexico imposed a limit on foreign currency liabilities held by commercial banks. This was initially set at 10 percent of average peso deposits plus foreign currency liabilities. In November 1992 there was some liberalization of these requirements to allow banks to acquire additional foreign currency liabilities in certain circumstances, e.g., for the granting of export credits.

Commercial banks are required to contribute to a bank insurance fund called FOBAPROA, managed by the Bank of Mexico. All banks make periodic contributions based on the level of their liabilities. Should a bank experience capitalization problems, the fund can inject capital in exchange for partial or complete control over the bank.

Since 1989, banks have been required to classify their loans according to five categories related to risk of nonperformance and to set aside reserves appropriate for each category. The proportion of total loans considered nonperforming has been growing due to portfolio problems inherited from the period of government ownership (which also hindered the development of credit analysis capabilities), high real interest rates, and low economic growth. Between December 1991 and December 1993, overdue loans as a percentage of total loans grew from 4.13 percent to 7.26 percent.

The nationalization of the commercial banks required banks to sever relationships with industrial groups and noncredit financial institutions. The 1990 Law for the Regulation of Financial Groups allows banks again to affiliate with two or more distinct types of financial institutions within a single holding company. Since then, financial groups have formed around most of Mexico's banks. As of March 1994, 23 of Mexico's banks were part of a financial group. The integration of banks within financial groups has resulted in some blurring of functions between banks and brokerage firms, as activities previously conducted by brokerage firms, such as money market operations and foreign exchange trading, have been transferred to the bank in the financial group.

A trend toward the consolidation of banks began in the 1970s and continued through the early 1990s. The number of banks was reduced from 139 in 1975 to 18 (excluding Citibank and Banco Obrero) at the time of privatization. The number was further reduced in 1993 with two bank mergers. This consolidation trend has been reversed by the issuance of new banking licenses intended to increase competition and improve the level of service provided by banks. Between June 1993 and March 1994, 14 new banks were authorized, a minority of which were in operation as of March 1994. Two of the 14 were national banks and the other 12 regional

banks. An additional three regional banks have been authorized since March 1994. On October 17, licenses to establish 18 foreign-owned banks were granted under the terms of NAFTA. Ten of these are U.S.-owned. (The other eight are U.S.-based subsidiaries of foreign parentage.) The foreign-owned banks are expected to be operating by the end of the first quarter of 1995. The Mexican government expects that around 60 banks, including both Mexican and foreign-owned institutions, will be authorized to operate by the end of 1994.

Mexico's banks are authorized as national, regional, or multiregional banks (based upon the market they are allowed to serve). The 18 privatized banks included six national banks, seven multi-regional banks, and five regional banks.

Mexico's commercial banks recorded assets of $202 billion equivalent as of December 1993. Outstanding loans constituted $128 billion equivalent, or 63 percent of total assets. Liabilities of $189 billion equivalent included deposits of $112 billion equivalent, or 59 percent of liabilities, and capital amounted to $13 billion equivalent. Private deposits tend to make up a smaller proportion of bank liabilities in Mexico than in the United States. Therefore, banks tend to rely on other sources of funding such as international loans, repurchase agreements, and money markets. In the money markets they can borrow from corporate and institutional lenders. On the lending side, some members of the banking community believe that bank loan data is somewhat inflated because bad debt in not adequately accounted for. The market share of the commercial banking system is highly concentrated. The three largest banks hold 50 percent of all assets, 53 percent of all loans, and 59 percent of the net worth. Financing to the private sector grew rapidly in the early 1990s as the public sector's demand for funds decreased with the elimination of the fiscal deficit. Real growth in financing going to the private sector rose an average of 50 percent annually between 1990 and 1993. The rate of growth slowed significantly in 1993 as banks reverted to more conservative lending policies.

The introduction in May 1992 of a private retirement savings system (SAR) increased the pool of funds available to banks. The SAR requires employers to pay the equivalent of 2 percent of payroll into individualized workers' accounts in banks, insurance companies, or brokerages. As of December 1993, banks had investments of SAR funds of $5.1 billion equivalent.

Mexican commercial banks can issue three categories of voting stock (ordinary capital): A, B, and C. Series A shares must constitute 51 percent of a bank's voting shares and must be held by Mexican individuals, the federal government, development banks, FOBAPROA, or financial group holding companies. The remaining 49 percent of voting shares may be made up of A, B, or C shares. Series B shares may be acquired by the same investors eligible to purchase Series A shares and certain other Mexican entities. Series C shares may make reach up to 30 percent of ordinary capital and may be acquired by Mexican or foreign investors. Nonvoting stock may also be issued in the form of Series L shares. L shares may reach the equivalent of 30 percent of voting capital and may also be acquired by foreign investors. Subsidiaries of U.S. and Canadian banks established under NAFTA must be at least 99 percent owned by the parent

institution and issue a different single series of shares.

The Law on Credit Institutions and other laws governing Mexico's financial sector were modified in mid-1993 in order to provide greater flexibility and increase the competitiveness of Mexican institutions. Reforms to the Law of Credit Institutions include a catalog of actions that will draw National Banking Commission sanctions and allows banks to undertake financial leasing.

Development Banks

The banking system in Mexico includes seven government-owned development banks that lend to priority sectors, often through commercial banks or other financial institutions. Since 1993, the activities of development banks have been considered off-budget for the federal government. Development banks have been moving toward market-based financing and lending and moving away from subsidized lending. As of December 31, 1993, development banks held assets of $62.9 billion equivalent. Loans made up almost 74 percent of assets. Benefiting from Mexico's improved credit rating, development banks have been borrowing actively on local and international capital markets. Funds raised with overseas issues and local securities grew from 6 percent of liabilities in 1991 to 18.5 percent in 1993.

The dominant development bank is Nacional Financiera (NAFINSA), the development bank for micro, small, and medium-sized business. Nafin is the government's agent for international financial transactions and also promotes capital market development. Nafin operates a neutral investment fund through which foreign investors may purchase an interest in Mexican equity. It has 49 percent of development bank assets and 50 percent of liabilities. The nation's export finance bank, Bancomext, holds 24 percent of all development banks assets and 28 percent of liabilities. With the slower growth in commercial bank lending in 1993, growth in private sector credits provided by development banks has been especially important in meeting demand for credits.

U.S. PRESENCE IN THE MARKET

Currently, the only foreign bank operating in Mexico is Citibank, which was grandfathered into the banking system when legislation was passed excluding foreign banks from operating in Mexico. Citibank had assets of $2.8 billion in 1993, with over half in securities and 14 percent in the form of loans. It had liabilities of $2.7 billion, of which deposits were 23 percent, and paid-in capital of $66.3 million. As of March 1994, Citibank had six branch offices, an increase of one since 1990. Citibank's activities have been restricted. Bank capital and the number of branches have been limited, and there are prohibitions on the operation of trusts and on offering loans with a maturity of over five years. Citibank has received authorization to change its status from a branch operation to a subsidiary, which will dramatically improve its treatment.

In addition, as of February 1994, there were over 112 foreign bank representative offices in Mexico, of which 23 represented U.S. banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Bilateral Discussions and NAFTA

The United States and Canada negotiated the opening of the Mexican banking sector during the NAFTA negotiations. The implementation of NAFTA satisfied U.S. government demands for market access and set in motion a process that over time should result in national treatment for U.S. investors in the Mexican banking system.

The negotiation of the NAFTA by the United States, Mexico, and Canada established a new context for the operation of U.S. banks in Mexico. For the first time in over 50 years, U.S. banks and their Canadian counterparts may establish wholly-owned subsidiaries in Mexico and may acquire existing Mexican banks, subject to certain limits discussed below. Before NAFTA, all foreign investors were limited to a 30 percent share of voting capital in Mexican banks, and U.S. banks could establish a presence only through a representative office. U.S. and Canadian investors establishing a subsidiary in Mexico must hold at least 99 percent of its capital.

NAFTA was implemented effective January 1, 1994. It commits Mexico to apply the principle of national treatment to U.S.- and Canadian-owned financial institutions. The purpose of national treatment is to promote equal competitive opportunities. This means that U.S.- and Canadian-owned bank subsidiaries will be able to engage in the full range of banking services offered by Mexican banks.

Individual and aggregate banking market share limits apply to U.S. and Canadian bank subsidiaries during a phase-in period. Between 1994 and 2000, an individual bank is limited to net capital of 1.5 percent of the total net capital of all Mexican and foreign commercial banks. As of December 31, 1993, the net capital of commercial banks totalled 50.4 billion new pesos ($15.3 billion equivalent at the May 1994 exchange rate of 3.3 new pesos/dollar), which put the individual market share limit at 755 million new pesos ($229 million).

The aggregate net capital of U.S. and Canadian banks is limited to 8 percent of the net capital of the system in 1994 ($1.22 billion equivalent as of May 1994), increasing in equal annual increments to 15 percent in 1999. Net capital is a measure that includes basic capital, essentially paid-in capital plus capital reserves adjusted by retained earnings and asset valuations, and complementary capital. These market share limits will disappear in the year 2000, but between 2000 and 2004 the Mexican government will be able to cap the market share of U.S.- and Canadian-owned banks for up to three years if it reaches 25 percent of the capital of the system. U.S. banks may acquire Mexican banks as long as the combined capital of the acquired bank and

a foreign subsidiary of the investor does not exceed the market share limit or, after the transition period, 4 percent of the capital of the system. This effectively precludes the acquisition of Mexico's largest banks by foreign investors.

Several minor negotiated exceptions to the principle of national treatment allow differential treatment of foreign and Mexican investors. The most significant limits the sale of subordinated debentures by foreign-owned banks, during the transition period, to only their foreign owners.

In April 1994, the Ministry of Finance published its regulations governing applications by foreign financial institutions for approval to establish a subsidiary. U.S. and Canadian banks had until July 31, 1994, to complete their applications. On October 17, 1994, the Mexican Finance Ministry granted 18 licenses to U.S.-based banks for the establishment of Mexican subsidiaries. Ten of the banks are U.S.-owned. The others are the U.S. subsidiaries of European and Japanese banks. The banks are expected to be operating by the end of the first quarter of 1994.

No new privately run credit information system made possible by 1993 reforms to the Law to Regulate Financial Groups is yet operational, although several companies have shown interest in developing projects. Concerns have been expressed that restrictions will be imposed on the access by some credit institutions to information available through an existing reporting system owned by Mexican banks, which is currently being modernized, and that such restrictions might prejudice U.S. interests. The U.S. government has made preliminary contacts to ensure that all firms enjoy the same access to the information provided by the system.

Supplemental Information

Mexico's laws permit foreign investment of up to 49 percent of paid-in capital of general deposit warehouses, financial leasing companies, financial factoring companies, bonding companies, and limited scope finance companies. The latter were first authorized in 1993. Under NAFTA, U.S. and Canadian investors may own up to 100 percent of these companies. The following market share limits apply between 1994 and 1999, after which market share restrictions disappear:

Maximum Aggregate Foreign Market Share		
	1994	1999
Factoring	10	20
Leasing	10	20
Limited Scope Finance Companies	Up to 3 percent of the assets of all commercial banks in Mexico plus the assets of all limited objective financial companies	

Note: As of July 31, 1994, the Mexican government had received applications from U.S. and Canadian institutions for 17 limited scope companies, 12 financial leasing companies, and 4 factoring companies.

Assets and Liabilities of Mexican Commercial Banks
(millions of new pesos at year-end)

	1991	1992	1993
Total Assets	407,354	493,626	627,727
Liquid	15,006	13,574	14,153
Securities	114,387	89,613	109,270
Loans	220,026	314,439	395,951
Other	57,934	76,001	108,353
Total Liabilities	385,307	463,193	588,191
Deposits	236,340	286,556	347,845
Other Liabilities	148,968	176,727	240,346
Capital	22,047	30,433	39,536

Assets and Liabilities of Mexican Development Banks
(millions of new pesos at year-end)

	1991	1992	1993
Total Assets	115,343	144,773	195,424
Liquid	3,964	3,341	3,347
Securities	9,544	12,165	17,795
Loans	92,485	113,183	144,013
Other	9,350	16,084	30,269
Total Liabilities	104,865	131,037	179,792
External Financing	67,387	74,534	77,470
Internal Financing	9,564	11,642	11,348
Deposits	2,314	4,516	5,778
Securities	11,768	19,849	43,102
Other	13,833	20,495	42,094
Capital	10,477	13,736	15,632

Source: National Banking Commission

Exchange Rates

End of year 1990:	$1 = 2.9432 new pesos
End of year 1991:	$1 = 3.0710 new pesos
End of year 1992:	$1 = 3.1154 new pesos
End of year 1993:	$1 = 3.1059 new pesos

MEXICO

SECURITIES

SUMMARY

The North American Free Trade Agreement (NAFTA) opened up the Mexican securities market to U.S. and Canadian firms. For the first time, U.S. securities companies, securities specialists, and investment fund managers have the right to engage, through their local subsidiaries, in the full range of activities undertaken by Mexican securities companies, as NAFTA guarantees the application of national treatment. During a transition period from 1994 through 1999, U.S. and Canadian securities firms will be subject to market share limitations. As of August 1994, there were 28 brokerage houses operating in Mexico. Licenses to establish nine U.S.-owned securities firms were granted on October 17, 1994. The firms are expected to begin operations within five months of that date.

Mexico has one securities exchange, the Bolsa Mexicana de Valores. The exchange has two sections, the main exchange and a market for smaller companies with lower capitalization. The introduction of a section for trading securities issued in overseas markets is underway. The 290 mutual funds in operation had assets of $26 billion as of year-end 1993.

Trading in money market operations dominates the securities market, accounting for 98 percent of trading activity. Money market trading is concentrated in government paper. A total of $66.4 billion in government securities was outstanding as of April 1994.

The securities market is regulated by the National Securities Commission, the Ministry of Finance, and to some degree the Bank of Mexico. The Mexican Stock Exchange and the Mexican Association of Trading Intermediaries exercise self-regulatory functions.

Foreign investment is increasingly important, amounting to almost 27 percent of stock market capitalization and over 60 percent of holdings of government securities held outside the Bank of Mexico (the Central Bank) as of April 1994. Foreign entities may invest freely in government debt securities. Foreign investors may acquire nonvoting shares in Mexican equities through mutual funds, trusts, offshore funds, and American Depository Receipts. In addition, they may directly buy free subscription shares, known as "B" shares, which are open to foreign and Mexican investors and carry voting rights. Foreigners may also freely purchase limited or nonvoting shares ("C" or "N" shares). And through a neutral fund operated by Nacional Financiera, they may purchase stock normally reserved for Mexican investors, "A" shares.

DESCRIPTION OF THE MARKET

Domestic Securities Market

Mexico has one established securities exchange, the Bolsa Mexicana de Valores. The Bolsa trades stocks and warrants, fixed-income securities issued by Mexican companies, government securities, and a very small volume of metals contracts.

The exchange, with roots in the 1890s, took its modern form in the 1970s when it became an autonomous institution. The Securities Market Law of 1975 established regulations pertaining to brokerage houses and a framework for the issuance of private and public securities. Market development accelerated in the late 1970s with the introduction of Treasury bills, unsecured corporate bonds, a centralized deposit institution (INDEVAL), and more authority for regulatory agencies. Brokerage houses developed rapidly during the 1980s after Mexican commercial banks were nationalized and forbidden from trading on the floor of the stock exchange.

The securities market is regulated by the National Securities Commission, a semi-autonomous agency of the Ministry of Finance. Since 1993, the commission has been part of the International Organization of Securities Commissions. The Ministry of Finance and the Bank of Mexico also have regulatory authority. The Mexican Stock Exchange and the Mexican Association of Trading Intermediaries act as self-regulating organizations (SROs). Reforms to the Securities Market Law in 1993 enhanced the self-regulating functions of the stock exchange.

As of August 1994, 28 brokerage houses were in operation (13 of these had U.S. offices). Two of the brokerage firms began operation in 1994. Brokerage commissions are not regulated, so brokers can set their own rates for various transactions. Brokerage houses conduct most trading, but the money market and foreign exchange desks at banks also are active in buying and selling securities. The formation of financial groups, holding companies that control two or more distinct types of financial intermediaries, has encouraged some shifting of functions from brokerage subsidiaries to the associated bank. Twenty-one of the 28 brokerage houses were part of various financial groups as of March 1994.

Four rating agencies have been authorized to operate in Mexico. These include CAVAL, which was purchased by Standard and Poors' in 1993, and the U.S. firm Duff and Phelps, which is expanding its presence in Mexico.

Stock Market

The stock exchange has two markets — the main exchange and an intermediate market — with capitalization of $181 billion in April 1994 (approximately 50 percent of GDP, versus 14 percent of GDP in 1988). As of December 1993, the main exchange listed 190 companies and 388 stock series. The number of listed companies has since grown to over 200. According to a

marketability measure introduced in 1989, of 253 shares measured for marketability, 22 listed firms were considered of high marketability, 52 of medium marketability, 91 of low marketability, and 88 of minimal marketability. The average daily volume of trading was 108 million shares in 1993, up from 99 million shares per day in 1992 and only 33 million shares per day in 1988. The stock of Telefonos de Mexico, the government's telephone monopoly, accounts for approximately one-third of trading volume and one-third of the index's value.

An automated second-tier market began operations in the second half of 1993. It allows companies to list on the stock exchange with lower capitalization and trading requirements. As of April 1994, two companies were listed on the intermediate market. By August, there were six companies listed.

Stocks are sold for cash or for 48-hour settlement. Short sales were introduced in 1991 on stocks with high marketability, although the volume of short sales has been relatively low — in 1993, trading in short sales amounted to 28.3 million shares. Warrants were introduced in October 1992, and there are 109 warrant issues currently outstanding. Forward sales are not currently permitted, but a coverage instrument (Cobertura) is available for foreign exchange. Foreign exchange coverage is a form of insurance against adverse movements of the peso and is available for periods of up to 180 days. Money market intermediaries use offsetting buy and sell repurchase operations as a form of coverage.

Money Market

Money market operations dominate trading activity on the Mexican Stock Exchange, accounting for 98 percent of the value of securities traded. The Bank of Mexico began using open market operations for monetary regulation in the late 1980s, which promoted the development of the money market. The most important money market instrument in Mexico is the Cete (Certificado de la Tesoreria de la Federacion), the Mexican treasury bill. Cetes are discount bills with a par value of 10 new pesos and are available in maturities of 28, 91, 182, 364, and 728 days. Two-year Cetes were introduced in August 1993 to enable the Mexican government to extend the maturity profile of its debt.

Cetes are auctioned weekly by the Bank of Mexico, usually in a multiple-rate auction; most Cetes are purchased by institutional investors such as banks, brokerage houses, and pension funds and insurance companies. Cetes are sold in the secondary market directly or through repurchase operations.

Tesobonos (bonos de la tesoreria de la federacion) are treasury bills denominated in U.S. dollars and payable in pesos at the market rate of exchange at the time. Tesobonos are available in maturities of 28, 91, 182, and 364 days. Because tesobonos are payable in pesos at the market rate at the time of maturity, they are used to hedge foreign exchange risk. Tesobonos are auctioned weekly by the Bank of Mexico.

The most important private money market instruments include bankers acceptances, issued for maturities of 7 to 128 days, and commercial paper, which is sold at a discount for maturities of up to 91 days. The value of these instruments issued has grown in recent years, but they still represent a minute portion of overall money market trading.

Capital Market

The Bank of Mexico sells by auction two principal long-term government securities. Bondes (bonos de desarollo) are development bonds sold in one-, three-, and five-year maturities. They have a face value of 100 new pesos and are sold at a discount. Bondes pay interest every 28 days indexed to the 28-day Cete yield. In 1993, Bondes accounted for almost 86 percent of money market trading in terms of value due to the amortization of large amounts of Bondes.

Ajustabonos are three- and five-year bonds whose interest payments and redemption at maturity are indexed to inflation in order to guarantee a real return over inflation. Ajustabonos pay interest quarterly based on the 100 new peso par value adjusted by the consumer price index.

New Financial Products

Generally, new financial products must be approved before being introduced or marketed. Variable rate instruments and some derivative instruments (such as swaps, warrants, and some structured instruments) exist but the range of products and activities is not as extensive as it is in the United States (forwards, options, and futures are not currently permitted). The authorities tend to be conservative in the approval of new instruments but are working to expand the range available. Foreign participants are eager to see the development of futures, options, and forward rate agreements.

Mutual Funds

To the extent allowed by NAFTA's provisions, through wholly-owned subsidiaries, foreign banks and foreign securities firms may offer and manage mutual funds. Foreigners may also own mutual fund management companies not affiliated with banks or securities firms. Foreign mutual funds may not currently be sold to investors in Mexico. However, gradual liberalization of these restrictions is expected.

At the end of 1993, there were 290 mutual funds operating in Mexico as common equity funds, debt funds, and capital investment funds, with total assets of $25.9 billion. This was an increase of 56 percent over 1992 but still below the peak of $27.4 billion at the end of 1991. Over 80 percent of mutual funds assets were invested in debt securities.

Internationalization

The Mexican securities markets are becoming increasingly internationalized. High real interest rates in Mexico in 1992 and 1993 and again in the spring of 1994 attracted large amounts of portfolio investments from overseas, especially into government securities. Foreigners may invest freely in government securities, and as of April 1994, foreign investment amounted to over 60 percent of the value of outstanding securities outside of the Bank of Mexico. Foreign investment is highest in Cetes.

Foreign investment in the voting stock of Mexican companies is limited to a minority position in certain sectors, including most financial companies. However, foreigners may purchase nonvoting ("neutral") shares through trusts or mutual funds directly on the Mexican Stock Exchange. Foreign investors may directly buy free subscription shares, known as "B" shares, which are open to foreign and Mexican investors and carry voting rights. Foreigners may also freely purchase limited or nonvoting shares ("C" or "N" shares). And, since 1989, they may purchase stock normally reserved for Mexican investors, "A" shares, through a neutral fund operated by Nacional Financiera. Foreigners may also invest through offshore funds or through American Depository Receipts (ADRs). ADRs are certificates that represent a set number of shares of stock and are traded in the U.S. markets or other international markets in a similar form. As of March 1994, there were 72 Mexican ADR issues with a capitalization of $145.6 million of a total market capitalization of $203.8 million (71.5 percent). Foreign investment in equity is highly concentrated in approximately 15 companies.

As of April 1994, foreign investment in Mexican equity amounted to $48 billion, or 26 percent of market capitalization. Investment through American Depository Receipts (ADRs) represented 62 percent of foreign investment. Foreign investment has been an engine of high growth. The stock market price index rose 47 percent in 1993, and a total of 450 percent between 1988 and 1993.

As the federal government's financing needs have diminished, financing to the private sector has increased. From 1990 to 1993, $14.2 billion was raised through stock offerings (64 percent overseas). The value of public offerings rose from $224 million in 1990 to $4.4 billion in 1993, and the value of outstanding private and bank debt rose from $5.4 billion in 1990 to $24 billion by the end of 1993. Almost all nonfinancial private debt issues are now rated.

Recent Developments

An automated transaction system (SATO) was introduced as part of the main exchange in 1993 for stocks with lower marketability. The volume of trading handled through the SATO is currently low compared to trading on the floor of the exchange, but as it matures the system will link brokerage firms in other locations to the stock market. The Mexican Stock Exchange also has an automated stock monitoring system.

The Securities Market Law was reformed in 1993 to permit securities issued in foreign markets to be traded on the Mexican Stock Exchange, expand the powers of securities depository institutions, and restrict limited or non-voting shares to 25 percent of listed companies. Also in 1993, mutual fund operators independent of banks and brokerage houses were authorized.

The Mexican authorities are developing projects to introduce trading in stock options and in futures on stock and consumer price indexes. Plans for an international quotation system on the Mexican Stock Exchange are underway. This system would trade stock issued overseas, beginning with the overseas issues of Mexican companies.

U.S. PRESENCE IN THE MARKET

Until the implementation of the NAFTA, effective January 1, 1994, foreign securities firms were not permitted to maintain a presence in Mexico. Sixteen U.S. companies applied to establish brokerage house subsidiaries by the July 31, 1994 deadline. Nine of these are U.S.-owned. (The other seven are U.S.-based subsidiaries of foreign parentage.) Licenses to establish securities firms were granted to all applicants on October 17, 1994. The firms are expected to be operating by the end of the first quarter of 1994. Recent changes to the Securities Market Law permits foreign securities firms to open representative offices in Mexico. Direct branching is not permitted.

To establish a subsidiary, U.S. and Canadian investors must hold at least 99 percent of the shares of the company, issued in one series (Mexican law dictates that subsidiaries may only issue one series of stock). Otherwise, their investment in the securities sector, as with all other foreign investors, is limited to the following minority positions:

- brokerage houses: 30 percent of social capital[1].
- securities specialists: 50 percent of paid capital.
- mutual funds and investment company managers: 49 percent of fixed capital.

Mexican law also limits individual foreign investments in securities firms and specialists to 10 percent of authorized capital (individual Mexican investments can reach up to 15 percent with specific approval). Foreign investment in the fixed capital of mutual funds is limited to 49

[1]Mexican law defines several classes of capital. "Social capital" refers to the amount defined in the constituting act of a company as the value of the amounts contributed by the owners; "paid-in" capital is a part of social capital which the owners have bought with materials (fixed assets or merchandise) or monetary resources (money or equivalent means of payment); "fixed capital," in a mutual fund, is represented by stock without the right to retire, which can only be issued with the approval of the National Securities Commission. The difference in capital allowance between brokerage houses and securities specialists is partly explained by differences between the categories of capital involved; it is also a recognition that brokerage firms have a fuller range of activities.

percent.

It is expected that, in the future, brokerage houses will be permitted to manage retirement funds collected through the mandatory but privately run social security system called SAR.

Currently, no foreign securities, including foreign mutual funds, are available in Mexico. The key to providing access to foreign securities will be an international quotations system which, if implemented as planned, will permit automated trading in approved securities on approved exchanges.

Mexican residents may issue equity and debt securities in overseas markets, and Mexican companies have been among the most active developing countries in doing so. Overseas issues are subject to prior approval from the regulatory authorities for prudential reasons. The United States is the most important overseas market for Mexican issuers, and U.S. firms are actively involved in underwriting Mexican offshore securities issues.

The government recently created a Financial Opening Committee made up of representatives of the Ministry of Finance, the Bank of Mexico, and the National Securities, Banking, and Insurance Commissions. This committee will monitor the applications and operation of foreign financial institutions to ensure they meet the rules established and to see that the same regulation applies to foreign-owned and Mexican-owned institutions.

NORTH AMERICAN FREE TRADE AGREEMENT

The North American Free Trade Agreement (NAFTA) opened up the Mexican securities market for U.S. and Canadian firms. Under NAFTA, U.S. and Canadian securities firms, securities specialists, and mutual fund management companies can enter the Mexican market for the first time through wholly-owned subsidiaries. NAFTA guarantees the principle of national treatment for these institutions. U.S.-owned subsidiaries will be able to engage in the full range of activities open to Mexican-owned securities firms and will be subject to the same rules and regulations.

The signatories to the NAFTA agreed to limitations on the size of U.S. and Canadian securities companies. These limits will be enforced on the individual and aggregate market share of U.S. and Canadian subsidiaries during a six-year transition period from 1994 through 1999.

The individual market share limit caps the authorized capital of a single securities firm at 4 percent of the global capital of all Mexican and foreign securities firms. Global capital is, approximately, paid-in capital and capital reserves adjusted by earnings and changes in asset valuation. As of December 31, 1993, the global capital of Mexican brokerage houses was $1.9 billion, which puts the maximum size of a single U.S. brokerage subsidiary at 252.1 million new

pesos, or $76.4 million ($1 = 3.3 new pesos).

The aggregate capital of U.S. and Canadian firms is likewise limited to 10 percent of the global capital of all securities firms in Mexico in 1994. As of December 31, 1993, this amount was 630,275,700 new pesos, or $191 million. This ceiling on aggregate capital increases in equal annual increments to 20 percent as of 1999 and is eliminated in the year 2000. During the period 2000-2004, however, the Mexican government may freeze for up to three years the global capital of U.S. and Canadian firms if it represents 30 percent of aggregate capital.

In April 1994, the Mexican government issued rules governing the establishment of subsidiaries of foreign financial companies. Securities firms and specialists were required to identify the activities they will undertake (e.g., stock market, money market, intermediate market, corporate finance) and the market segment they will serve. Mutual funds must outline their investment, sales and service policy. Licenses to establish 16 securities firms were awarded on October 17, 1994.

Annual Volume Traded
(millions of dollars)

	1991	1992	1993
Equity	39,392	50,547	64,210
Fixed-income	8,128	10,448	17,513
Total Capital Market	47,520	60,995	81,723
Treasury Bills	1,533,081	3,283,340	456,798
Bondes	38,620	77,832	3,896,135
Tesobonos	330	2,774	1,986
Ajustabonos	88,830	154,086	178,710
Commercial Paper	21,177	14,878	14,702
Bankers Acceptances	1.0	237	293
Other	1,720	2,386	2,803
Total Money Market	1,683,760	3,535,532	4,551,427
Metals Market	8	6	3
Total Securities Market	1,731,288	3,596,532	4,633,154

Exchange Rates

Average 1993: $1 = 3.1156 new pesos
End of year 1993: $1 = 3.1059 new pesos

ARGENTINA

BANKING

SUMMARY

The Argentine banking sector is dominated by public sector banks, which have 46 percent of deposits (as of November 1993). The government-owned banks have the advantage, compared to their private domestic and foreign counterparts, of an effective monopoly on public sector deposits. On the other hand, public sector banks are more likely to be subject to some restraints on their ability to make decisions based solely on commercial considerations. Private Argentine banks tend to be relatively small.

U.S.-based banks have been very active in the local banking market, in both retail and wholesale operations. Two U.S. banks — Citibank and Bank of Boston — are among Argentina's longest established banks. Of the 165 banks presently licensed, eight are either branches or wholly owned subsidiaries of U.S. institutions. At year-end 1993, these eight U.S. banks operated 77 branches in Argentina and held $2.7 billion in deposits (about 7 percent of total deposits). Foreign banks account for over 19 percent of Argentina's banks and over 16 percent of Argentina's bank deposits.

As of June 30, 1994, three Argentine banks operated two branches and two agencies in the United States (one bank operates one branch and one agency). Two other banks have representative offices. One has filed an application to open a representative office in New York, and another has filed an application to establish a New York branch.

Changes introduced by the Argentine Central Bank (BCRA) in early 1994 eliminated all legal constraints on the establishment, acquisition, or branching of foreign banks. However, prudential limits are based upon the local capital of the branch rather than on the consolidated capital of the parent corporation. There are no legal or regulatory constraints or impediments on U.S. banks regarding funding activities or introducing new financial products. Foreign financial institutions have indicated that banking rules and regulations are transparent and that they have a sufficient opportunity to make appropriate comments on changes.

DESCRIPTION OF THE MARKET

The Argentine banking industry is still re-establishing itself as a reliable financial sector after decades of imprudent management on a systemwide basis. The extreme economic instability that Argentina endured during the 1980s, culminating with the hyperinflationary episodes of 1989-90, led to a precipitous fall in public confidence in the banking system. In 1980, there were 214 banks operating in Argentina; at the end of 1993, 165 remained. (The number of nonbank financial entities dropped from 255 in 1980 to 40 over the same period.) The real value of deposits fell by more than 50 percent from 1980 to 1989.

The overall banking system has the following characteristics:

- It is highly concentrated: as of November 1993, of the 165 banks, nine banks controlled 50 percent of all deposits.

- It is dominated by public sector banks, which control 46 percent of all deposits.

- It has recently evolved into a bimonetary (peso and U.S. dollar) system: 97 percent of deposits were in pesos in 1988, compared to only 51.5 percent today.

- The public sector is no longer a net user of new credit now that the federal government has achieved a structural fiscal surplus (although a large stock of debt remains, almost exclusively at the provincial level).

Profile of Argentine Banking System
November 1993
(deposits in billions of U.S. dollars or equivalent)

	All Deposits	All Loans	No. of Banks	No. of Branches
U.S. Banks	2.7	3.3	8	77
All Foreign Banks	6.3	7.7	32	535
All Private Banks	14.5	15.4	60	1287
Public Sector	18.2	19.1	73	2282
All Banks	39.0	42.2	165	4064

Source: Central Bank of the Argentine Republic (BCRA)

Especially important among the public sector banks are Nación, Provincia, and Ciudad, which together have a total market share of 40 percent. An important factor underlying the role of the public sector banks is their monopoly on public sector deposits and the administration of public sector funds.

Concentration in the private sector is far less pronounced. Even the largest private banks command a relatively small market share of deposits (about 5 to 7 percent). In addition, the private sector banks remain very small by international standards, with total assets not exceeding $2.5 billion.

Despite the drop in the total number of banks in the last decade, the sector is still considered to be "overbanked." Many banks (including virtually all of the public sector banks) remain

overstaffed and operate at a low level of efficiency. These inefficiencies have resulted in higher financing costs for the borrower and decreased resource mobilization throughout the economy.

Economic stability and growth (i.e., inflation rates approaching international levels of industrialized countries and GDP growth rates second only to China in 1991-93) have helped inspire greater confidence in the overall banking system and generated much higher levels of demand for all types of financial services. Both the need for firms to restructure to meet the new challenges implied by the government's open trade policies and the growth of consumer confidence have led to dramatic growth in the demand for credit. As of January 1994, deposits held by the Argentine banking system totaled $40.2 billion ($21.7 billion in pesos and $18.5 billion in dollars), up fourfold in three years.

Recent Policy Developments

The present government has attempted to correct mistakes of the past. Its principal innovation in the banking system has been the changes in the BCRA through the Convertibility Law and a revision of the BCRA's Charter that was approved by Congress in September 1992. These laws require that the BCRA:

- operate independently of the executive branch;
- limit its monetary policy to ensuring the parity exchange rate between the peso and U.S. dollar;
- limit its financing of the Central Government to the purchase of dollar-denominated public bonds within specific limits;
- limit its assistance to the banking sector by only offering assistance for temporary liquidity problems on a fully secured basis; and
- eliminate explicit deposit insurance, replacing it with a very limited system of first-claim rights on a failed bank's assets.

Other systemic changes include:

- the establishment of more appropriate prudential requirements, including a revised minimum capital requirement program that, in some instances, exceeds the Basle recommendations;
- the elimination of the myriad of schemes involving directed credits and other controls the BCRA once administered;

- the introduction to the market of greater competition through more liberalized rules governing the opening of new banks and branches;

- the freeing of remittances to foreign owners of local banks; and

The BCRA also is working to improve its banking supervisory capabilities. Towards this end, the BCRA has relied upon technical assistance offered by the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York. The power and authority of the Banking Superintendent has been strengthened, and new auditing regulations are to be imposed that will promote greater transparency throughout the system.

U.S. PRESENCE IN THE MARKET

Eight of the 32 foreign banks operating in Argentina are home-based in the United States. (Until recent changes in the law eliminated all distinction between foreign and domestic banks, foreign ownership of more than 30 percent of a bank's capital qualified it as "foreign.") At end-1993, foreign banks held 16 percent of all bank deposits, of which U.S. banks held 7 percent.

Only two of the U.S. banks licensed to serve the Argentina market remain active in retail banking: Citibank (with 25 offices) and First National Bank of Boston (with 39). The other U.S. banks operating in Argentina are Chemical Bank (two offices), Morgan Guaranty (two offices), Chase Manhattan (two offices), Continental Illinois (two offices), Republic National Bank of New York (two offices) and the Bank of New York (three offices). All U.S. banks operate wholesale banking operations.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In January 1994, the Central Bank announced that it was lifting the ban on the issuance of new banking licenses. This ban had been in effect since 1984. In addition, a decree was promulgated in early 1994 to formally remove the legal distinction between foreign and domestic banks. The effect was to remove any legal constraints on the establishment of a foreign bank either as a branch or as a subsidiary. However, lending and other operations are limited based upon the local capital of the branch rather than on the consolidated capital of the parent corporation. This limitation tends to nullify an important reason for preferring establishment in branch form.

There are no legal or regulatory constraints or impediments, except prudential ones, placed on U.S. banks regarding their funding activities or the introduction of new financial products. Once established in Argentina, a foreign bank is eligible to seek BCRA permission to open branches in other parts of the country. Foreign financial institutions in Argentina have indicated that the

regulations and rules governing banking activities are transparent, and that there is sufficient opportunity for foreign banks to comment on regulatory/legal changes.

As noted above, there are differences in treatment between state-owned banks and their private counterparts, both domestic and foreign. In particular, almost all public sector deposits go to government banks. Moreover, public sector banks are the sole administrators of public sector funds. On the other hand, foreign banks face greater freedom in business decisions and in managing their personnel costs.

ARGENTINA

SECURITIES

SUMMARY

The overall economic significance of Argentina's securities market continues to be relatively small. Although most securities activities are represented, for the most part Argentina's capital markets are small compared to the size of the country's banking activities. Fund raising by the corporate sector still consists primarily of borrowing from banks.

New equity issues tend to be few, but the volume of trading and brokerage activities has increased substantially in recent years. The local bond market is dominated by public sector securities issues. However, recent changes in the legal structure governing bond issuance should help to expand underwriting opportunities in private fixed-income instruments. In addition, there is a small, locally based mutual fund market and the beginnings of a small private sector pension fund market.

Access to these markets is not restricted. Foreign securities firms may participate in the market as either a branch or a subsidiary. There are no laws or rules that discriminate on the basis of "domestic or foreign ownership." Nor are there restrictions on access by residents to financial instruments in foreign securities markets, or on access by nonresidents to financial instruments in Argentina's securities market.

Argentina's principal stock market, the Bolsa de Comercio, is located in Buenos Aires. Minor stock markets also exist in five other cities around the country. Argentina also has an over-the-counter securities market, the Mercado Abierto Electronico (MAE), which began as a loose grouping of the trading desks of local banks. A recent accord between the MAE and the stock market resulted in an agreement under which the MAE trades exclusively in bonds, while the stock market trades principally in stocks. In addition, there are small futures markets in currencies, stocks, and commodities.

At the beginning of 1994, there were 197 licensed stockbrokers and brokerage houses, of which four were affiliates of U.S. banks. Several U.S. securities firms deal in the stocks and securities markets using intermediary agents; two U.S. securities firms (Merrill Lynch and Goldman Sachs) have applied for seats on the Bolsa de Commercio, but are not yet licensed locally. In addition, several U.S. mutual funds are active in Argentina, and six U.S. firms are participating in pension fund management companies.

DESCRIPTION OF THE MARKET

Equity Market

Argentina's equity market is small by world standards, which tends to make trading thin and prices subject to greater volatility. Only a small percentage of total shares outstanding actively trade, and the issuance of new shares tends to be the exception rather than the rule. The reasons for the inactivity are historic, related to a tradition of Argentine entrepreneurs and large family-owned firms not wanting to cede or dilute operational control. The market also operates under less stringent information requirements, which provide investors with significantly less data than would be available in the United States.

The principal trading floor — the Bolsa de Comercio — was originally established in Buenos Aires in 1854. Smaller stock exchanges have been founded in five provincial cities. An electronic over-the-counter market based in Buenos Aires — the Mercado Abierto Electronico (MAE) — links the trading desks of many banks and has long since become the dominant venue in terms of trading volume. (An agreement reached in April 1993 limited direct competition in the trading of stocks between the Bolsa de Comercio and the MAE, leaving the Bolsa the sole market for stocks and the MAE the principal market for bonds.) Two other markets exist: Mercado de Futuro y Opciones (Futures and Options Market), and the Mercado a Termino de Rosario (Futures Market of Rosario). These markets trade stocks, federal government bonds, provincial government bonds, corporate bonds, guarantees and futures contracts, and other derivatives.

Until 1991, the stock market was fairly inactive, with daily trading volume of only $4 million being the norm. That amount was just one-tenth of the volume being traded in the 1950s, most likely a legacy of the extreme economic instability endured by Argentina in the 1980s. The success of Argentina's 1991 economic stabilization program, and subsequent investment interest by international investors, propelled the market to greater heights. Average daily trading volumes in August 1994 reached a record $630 million. In addition, market capitalization also has grown rapidly, increasing from just over $5 billion in March 1991 to $44 billion by year-end 1993. The increase was ostensibly the product of price increases reflecting rising demand from domestic and international investors, issuance of only a limited amount of new equities, and the listing of several attractive new firms on the bourse (including the listing of several privatized firms). In 1992, the Bolsa de Valores Exchange received nine new equity listing applications; in 1993, the Exchange received 16 applications.

The physical capability of the market to handle increased volumes of transactions is now becoming a major constraint to further growth. Many institutional improvements are needed, including better clearing procedures to reduce time-consuming delays that add significantly to transactions costs. The efficiency and flexibility of the market clearing mechanism, operated by Caja de Valores S.A., has improved recently, although clearing costs are still high compared

to other clearing organizations, such as Euroclear or other global organizations controlled by multinational banks.

Trading Volumes
(millions of dollars)

	1992	1993
Bolsa de Comercio		
Public Bonds	991	8,130
Stocks	15,857	50,512
Corporate Bonds	38	13
Mercado Abierto Electronico		
Public Bonds	93,054	203,072
Stocks	15,170	9,644
Corporate Bonds	247	195

Source: National Securities Commission (CNV)

Bond Market

The Argentine bond market is dominated by public sector securities, both in terms of issuance and in terms of trading activity and liquidity. New bond issues by corporations tend to be quite small compared to the amount of funds raised through banking sector products. In 1992, the Buenos Aires Stock Exchange approved applications for the listing of corporate bonds worth $540.7 million, submitted by 19 companies; in 1993, the Exchange received applications for the listing of corporate bonds totaling $427.2 million, also from 19 companies. There are no restrictions on the kinds of bonds that may be sold or underwritten in the Argentine market.

Profile of Bonds Traded on the MAE
(Millions of dollars or equivalents — as of December 31, 1993)

	In Circulation	Traded
Public Bonds	42,594	35,680
by Federal Government	42,252	35,392
in Dollars: Domestic	29,595	24,207
in Dollars: Abroad	8,677	6,981
in Pesos: Domestic	3,980	4,204
by Provincial Governments	98	69
in Pesos	2	0
in Dollars	96	69
by Public Enterprises	244	219
Corporate Bonds (in Dollars)	6,936	713

Note: "In circulation" exceeds "Traded" by the amount the Government of Argentina holds in its own accounts and does not trade.

Source: National Securities Commission (CNV)

Futures Trading

Trading in futures contracts exists to a limited extent, with the most developed of the futures markets being the Rosario Exchange where grain futures are traded. Other futures contracts traded include currencies and stocks. However, these markets are not well-developed, and they tend to lack volume and liquidity.

Pension Fund Management

Argentina's private pension fund management companies started accepting contributions from workers on August 1, 1994. So far, the amount of the private pension fund pool is estimated at $170 million per month. Annual inflows of new savings into the system are projected to be in the range of 2.5 to 3.0 billion pesos.

As of September 1994, Argentina had licensed 25 private pension fund management companies. Banks, securities firms, life insurers, and other financial institutions may participate in the management of private pension funds through separately run pension fund management companies licensed by the Superintendency. Six U.S. companies have shares in pension fund management companies.

Mutual Fund Market

In June 1992, the Argentine Congress amended the legislation regulating mutual funds. The new law was intended to promote low-cost, risk spreading options for small investors. The legislation authorized various investment options and the establishment of closed-end mutual funds, and it allowed exchange-based trading of mutual fund units.

At the end of 1992, there were 40 local mutual funds in operation. By mid-1994 there were 60. The total value of the 60 local mutual funds was about $265 million (267.8 million Argentine pesos) as of May 1994.

Foreign securities firms can create, manage, and sell foreign mutual funds in Argentina provided the public offering of the fund shares has been authorized by Argentina's National Securities Commission. There is no separate licensing requirement for securities firms to participate in mutual fund activities.

Regulation

The government is working to increase the efficiency of Argentina's capital markets in a variety of ways. Recently, the the National Securities Commission, the Commission Nacional de Valores (CNV), was reorganized to strengthen investor protection and support capital market development functions. The U.S. Securities and Exchanges Commission is supporting the CNV's ongoing institutional development. In addition, the legal framework governing the issuance of stocks and bonds has been revised, and rules governing the operation of mutual funds have been liberalized. The market's depth is expected to be improved substantially by the recently launched private pension system, which will encourage the development of long-term savings.

The self-regulatory powers of the Bolsa exchange has been strengthened as a result of agreements with the Argentine National Securities Commission (CNV). The CNV has delegated control over financial statements and related information disclosed by listed companies to the exchange. Applications for registration and new issues are filed and processed by the exchange, which issues an opinion on each filing and refers it to the CNV for final approval. The exchange approves applications for the listing of new securities.

To ensure consistency of financial reporting, the CNV shortened the frequency for submitting annual reports and quarterly financial statements. For small and medium-sized companies, the requirement to prepare audited quarterly financial statements was dropped entirely. Stock exchange and securities market fees were lowered, as well as transfer fees charged by the securities clearing corporation.

Corporations seeking to list securities on the Buenos Aires Stock Exchange need to obtain approvals from both the Securities Commission and the exchange. In practice, the commission and the exchange consolidate the procedures into a single application filed directly with the exchange. The commission and exchange group divides issuers into three categories: (1) a special section for issuers having capital of at least 60 million Argentine pesos, or annual sales of at least 100 million pesos or a minimum number of stockholders prescribed in listing regulations; (2) a general section, for small and medium-sized firms that do not meet special section criteria; (3) a new projects section, for corporations that do not list on other exchanges and are involved in investment projects for production of goods or services. This section is designed to promote access by new ventures to medium and long-term public savings. The commission and exchange listing rules also prescribe detailed reporting and disclosure requirements for all categories of companies.

U.S. PRESENCE IN THE MARKET

At the beginning of 1994, there were 197 licensed stockbrokers and brokerage houses in Argentina, of which four were affiliates of U.S. banks. Merrill Lynch, Lehman Brothers, and Prudential deal in stocks and securities markets using intermediary agents. Two U.S. securities firms (Merrill Lynch and Goldman Sachs) have applied for seats on the Bolsa de Commercio, but are not yet licensed locally. A number of foreign banks are members of the MAE.

U.S. financial firms provide a wide range of financial services to both the Argentine government and to private firms. Citibank and the Bank of Boston provide their services from their offices in Buenos Aires. Others, NationsBank for example, provide their financial services through correspondents and visiting executives. Not every bank provides every service, but the principal services offered include the overseas placement of international bonds for domestic issuers, international brokerage activities, and the taking of equity positions in selected privatizations.

In addition, U.S. financial services firms and U.S. management consulting firms have participated in advising the government of Argentina, as well as many private consortia, on matters related to the Argentine privatization process.

Six U.S. firms have entered Argentina's recently privatized pension fund market. And two U.S. firms (Citibank and Bank of Boston) are participating in the local mutual fund market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no laws or rules that discriminate between foreign and domestic firms in the Argentine securities markets. In February 1994, the Central Bank removed the legal distinction between foreign and domestic banks.

There are no legal constraints on establishment: 100 percent ownership in either branches or subsidiaries is permitted. Foreign securities firms, like their domestic counterparts, have full access to stock exchange seats.

Foreign-owned securities firms may underwrite equity and fixed-income securities instruments, and they may broker and trade both domestic and foreign securities. There are no legal impediments to the introduction of new financial products, including derivatives related financial products. However, these products are not common.

Foreign securities firms can also engage in fund management activities. They can engage in mutual fund activities directly and in pension fund activities through a separately licensed company.

There are no investment limitations on nonresidents in local equity and debt instruments; nonresidents may invest directly. Nor are there any legal limitations on the share of foreign ownership in a domestic company.

Residents of Argentina can freely access offshore securities instruments. Residents may freely access offshore markets as issuers of securities or notes. There are no capital controls. U.S. firms have participated in underwriting these issues.

Foreign financial institutions feel Argentina's regulatory environment is transparent and that they have sufficient opportunity to comment on prospective changes and sufficient notification of impending changes.

BRAZIL

BANKING

SUMMARY

The Brazilian Constitution regulates foreign participation in the financial sector. Under transitional provisions that have been in effect since 1988, the establishment of new branches and subsidiaries of foreign financial institutions is prohibited. This includes a freeze on increases in the percentage of foreign participation in the capital stock of Brazilian financial institutions. In addition, the number of branches (including automatic teller machines) of foreign banks cannot exceed the total existing on October 5, 1988. (Brazilian law does provide for possible exceptions to these restrictions under special circumstances; however, in practice the restrictions are binding.) The Brazilian Congress considered a number of revisions of the 1988 Constitution, but concluded its efforts on May 30, 1994, having taken no action on lifting the limitations. A new government is taking office in January 1995. However, it is considered likely that the current legal and constitutional restrictions on foreign financial institutions will continue into 1995.

Banking in Brazil has been greatly affected by the extremely high inflation rate that the country has experienced in recent years. In particular, banks have been able to earn favorable rates of return compared to other sectors of the economy by utilizing float, especially on non-interest bearing deposits. If the current macro-economic stabilization plan achieves success, banks will need to restructure their operations.

State-owned banks are an important part of the Brazilian banking scene, competing with private and foreign-owned institutions for a variety of banking business. The largest state bank, which is also the biggest bank in the country, has an important advantage over its competitors in that it acts as the depository for federal government receipts. This is particularly valuable in a highly inflationary environment where float accounts for a significant portion of profits. However, governmental institutions also are required to support administration policies, are subject to political pressures, and have correspondingly greater problems with poor loan portfolios.

As noted above, foreign banks have not been allowed to expand since the 1988. This has limited their ability to benefit from the float profits accruing in the industry. Foreign banks in Brazil also face higher minimum paid-in capital and net worth standards. An August 1994 change removes the prohibition on the establishment of automatic teller machine (ATM) networks by foreign banks. However, official approval is still needed. Moreover, the change did not affect the existing prohibition on the expansion of the total number of ATMs operated by foreign banks.

U.S. banks are well represented in Brazil. As of December 30, 1993, six U.S. banks operate (or have the right to operate) 119 branches in Brazil with total assets of $7.8 billion. This

represents a 48 percent increase in terms of assets from their position in 1989. In addition, four other U.S. banks have significant interests in Brazilian banks.

DESCRIPTION OF THE MARKET

Brazil's financial sector is large and sophisticated. The country's banking industry includes 238 banks operating 17,000 branches and an additional 12,000 service points. Banks are the primary purchasers of Brazilian government debt, which accounts for 5 percent of banks' total assets.

Public Sector Banks

Public sector banks play a significant role in the Brazilian system. The Banco do Brazil, which performed many central bank functions prior to the 1964 establishment of the Banco Central do Brazil (Central Bank), is the largest bank in the country. It acts as the government's agent in many transactions and is the depository for federal government receipts. It operates throughout the country competing with foreign and private institutions. It has the largest deposit base in the country and in the interior is frequently the only bank in town. It is also the primary lender to the rural sector, and is called upon to make loans to support Brazilian development projects. As a result it also has the largest bad debt portfolio (24 percent of credit operations and 34 percent of assets) of any bank in Brazil.

The Federal Savings Bank is the primary source of housing finance in the country. It administers funds derived from several taxes. It accepts deposits, including checking accounts, and is second only to the Banco do Brazil in its presence throughout the country. It is less competitive with private banks than the Banco do Brazil because of its narrower mandate. However, it accounts for over 22 percent of all savings deposits in the country.

The National Economic and Social Development Bank (BNDES) finances infrastructure and industrial projects. It also makes loans to companies with financial problems. Through BNDES, the Brazilian government is a shareholder in many Brazilian companies. It is one of the few sources of long-term financing in Brazil. Many of its resources come from international financial institutions. It is also funded by earmarked taxes. It does not engage in ordinary commercial banking and currently is not considered a competitor of private banks.

In addition, there are 23 state-owned banks and 3 federally owned, regionally operated development banks in Brazil. Public banks have certain advantages over banks in terms of capturing resources, but they also are subject to statutory mandates and political pressures to make poor quality loans. The bad debt portfolios of the public banks are considerably higher than that of the rest of the banking sector. The public banks also have much higher administrative costs because they have more personnel, who are difficult to let go.

Private Banks

Brazil's largest private banks began as family operations and have become diversified financial institutions. Family interests continue to be of importance in terms of ownership and sometimes management. The second largest bank in the country is the privately owned, Bradesco, with assets of $16.9 billion and deposits of $7.4 billion. (By contrast, Banco do Brazil has assets equal to $64.9 billion and deposits equivalent to $11.1 billion.)

All Service Banks

Private and public all-service multiple banks, authorized to operate by the Central Bank since 1988, now dominate the market. Multiple banks not only provide traditional commercial banking services, but also offer leasing, brokerage, and investment services. Many institutions, including foreign financial companies, have taken advantage of the greater flexibility afforded to multiple banks and have transformed their operations into multiple banks. They constitute 206 of the 236 financial institutions operating in Brazil, and include both government (23) and privately owned (183) banks. Other types of financial institutions have experienced a relative decline. For instance, commercial banks represented 70 percent of the total banking assets in June 1989, but now account for only 23.4 percent (almost 20 percent of the 23.4 percent pertains to the federal government-owned Banco do Brazil).

Financial Institutions
(percentage of total banking assets)
December 30, 1993

Multiple Banks (public and private)	46.06
Banco do Brazil (public)	19.18
Federal Savings Bank (public)	10.84
National Development Bank (public)	7.92
Commercial Banks (public and private)	4.22
Investment Banks (public and private)	3.17
Leasing Companies (private)	2.50
Stock Brokers (private)	2.46
Stock Distributors (private)	1.59
Real Estate Finance (private)	1.25
Finance Companies (private)	0.34
State Savings Banks (public)	0.19
State Development Banks (public)	0.17
Cooperatives (private)	0.11

Supervision

The National Monetary Council establishes the overall general policies for the financial system. The membership of the council includes the Ministers of Finance and Planning and the Central Bank President. (Until July 1994, it included 17 other ministers, officials, and private representatives.) The Central Bank oversees the entire system and has broad discretion to issue administrative rulings to execute policies set by the council. No deposit insurance system exists in Brazil. The 1988 Constitution calls for the establishment of a deposit insurance system, but implementing legislation has not yet been passed. At one time the Central Bank received a portion of the Financial Transactions Tax to fund bank liquidations. The Finance Ministry stopped this transfer as the public deficit grew. Therefore, if the Central Bank decides that it should compensate depositors in the event of a bank failure, it will have to request appropriated funds from the Congress to offset any shortfalls.

Impact of Inflation

The most influential factor influencing the banking sector has been Brazil's highly inflationary environment. The rate of inflation was running at several thousand percent annually until July 1, 1994, when a new currency was introduced (that has led, in the months following, to a dramatic drop in the rate of price increases). Although inflation depressed retail deposits, the banking sector has been a prime beneficiary of the inflationary environment, mainly because it was able to earn high yields on non-interest bearing deposits and float. As a result, banking sector profits tend to rise with inflation. The sector as a whole claims a much higher percentage of GDP in Brazil than in countries with lower rates of inflation. For example, in 1993 the inflation rate more than doubled, to 2,500 percent. Correspondingly, total profits of the six largest private banks (Bradesco, Itau, Bamerindus, Nacional, Unibanco, and Real) increased by between 37 and 41 percent for the year. Banking's share of Gross Domestic Product climbed to 10 percent, from 9 percent in 1992. The average rate of return on equity in 1993 of the 31 largest banks (which includes six less profitable state-owned banks) was 15 percent according to a Banco Norsul analyst, double that of the 31 largest businesses in Brazil (7.5 percent).

Banking Subsector	Return on Equity (percent)
Domestic Private Multiple Banks	16.2
Foreign Private Multiple Banks	15.7
Public Multiple Banks	11.6
Public Commercial & Savings Banks	10.8
Domestic Private Commercial Banks	9.8
Foreign Private Commercial Banks	3.3

Most of these profits stemmed from short-term credit operations charging more than 1 percent per day in interest. Due to high inflation, little money sits in deposit accounts ($15 billion in

December 1993), and banks are reluctant to extend loans for more than six months. Banks in Brazil earned approximately $14 billion in 1993 based on overnight loans using funds from deposits and other sources. The Central Bank estimated that the financial sector earned $8.9 billion from the so-called "inflation tax."

If the economic stabilization program succeeds in holding down inflation, banks will lose a large portion of their "float" profits and will probably shift to more traditional banking operations. Many private banks say they are prepared for this, but most analysts expect state-owned banks to suffer because of high personnel costs and large bad debt portfolios.

Total Assets of Brazilian Banking System
(in billions of U.S. dollars)

	December 1992	December 1993
Total Banks (236)	201.5	238.2
Largest Banks (21)	166.0	157.2
Foreign Banks (68)	32.7	38.4
U.S. Banks (6)	7.2	7.8

Net Worth of Banking System
(in millions of U.S. dollars)

	December 1992	December 1993
Total Banks (236)	21.9	24.7
Largest Banks (21)	18.2	16.9
Foreign Banks (68)	2.8	3.3
U.S. Banks (6)	0.5	0.5

U.S. PRESENCE IN THE MARKET

The U.S. banking industry has a significant presence in Brazil. Three banks — Citibank N.A., First National Bank of Boston, and J.P. Morgan — operate commercial bank branches of their U.S. parent corporations, with a total of 42 branches. Citibank and Bank of Boston also have organized Brazil-headquartered multiple banks, Banco Citibank S.A. and Banco de Boston S.A., with 24 and 38 branches, respectively. Banco Chase Manhattan S.A., a multiple bank, has shifted away from retail banking and closed all but two of its seven branches to focus on investment banking.

Morgan Guaranty purchased the branches and assets and received the grandfathered privileges of the Banca Commerciale Italiana. It is engaged primarily in investment banking. Banco American Express S.A. (one branch) and Banco General Motors S.A. (seven branches) converted former finance companies into multiple banks, but have not changed their primary focus. Bank of America and Bankers Trust own majority interests in two Brazilian banks (Multiplic and Planibanc, respectively) acquired after their local partners pulled out. Norchem, which is owned by Chemical Bank of New York, and Continental Bank own significant minority interests in two other banks.

Total Assets of U.S. Banks in Brazil
(in millions of U.S. dollars)

	1988	1993
Citibank N.A.	3,377.7	2,566.0
First National Bank of Boston	601.8	1,863.2
Chase Manhattan S.A.	1,160.7	1,103.5
Banco de Boston S.A.	20.9	879.0
Banco General Motors S.A.	1.9	349.6
*Morgan Guaranty Trust Co.	19.3	470.7
Banco Citibank S.A.	75.9	453.4
Banco American Express S.A.	.9	5.6

Net Worth of U.S. Banks in Brazil
(in billions of U.S. dollars)

	1988	1993 (Dec.)
Citibank N.A.	117.0	166.6
First National Bank of Boston	45.5	83.8
Chase Manhattan S.A.	57.7	104.0
Banco de Boston S.A.	4.1	62.0
Banco General Motors S.A.	0.8	29.0
*Morgan Guaranty Trust Co. NY	8.8	38.4
Banco Citibank S.A.	11.0	44.7
Banco American Express S.A.	1.0	5.5

Note: Both tables exclude Brazilian (national) banks in which U.S. banks have an interest. Data for Morgan Guaranty Trust Co. NY do not include operations of J.P. Morgan.

Citibank and Bank of Boston entered Brazil prior to 1940 as branches of their U.S. parent banks with full commercial bank rights. They retain this branch status as a grandfathered privilege. Post-World War II banks were not allowed to enter as branches. Both banks have also transformed other financial operations into multiple banks, as did General Motors and American Express with their financial companies. U.S. banks entering Brazil since World War II have

entered under a variety of rules that have changed over time and have not always been administered transparently.

In addition to those from the United States, 62 other banks with foreign participation operate in Brazil. These foreign banks represent France, the United Kingdom, the Netherlands, Germany, Italy, Portugal, Spain, Canada, Japan, Argentina, Paraguay, Uruguay, and Venezuela. As a group, foreign banks account for 16 percent of total banking assets in Brazil.

U.S. and other foreign banks are shifting from retail banking to trade and corporate finance due to their inability to compete in the Brazilian market with domestic banks because of restrictions on branches. Today, according to the interim President of Citibank in Brazil, trade finance accounts for 24 percent of Citibank's business, debt finance (purchasing government of Brazil (GOB) internal debt instruments) 23 percent, "hedges" 19 percent, capital finance (including administering investment funds) 18 percent, and 16 percent other business, such as retail and private banking. Bank of Boston claims the lead among foreign banks in Brazil in trade finance.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Brazil's 1988 Constitution calls for the Brazilian Congress to consider restructuring of the financial system. Article 192 of the Constitution requires that Congress pass a complementary law defining the conditions for foreign capital participation in Brazil. Various legislative proposals have languished in Congress. As a result, Article 52 (a transitional provision), which includes the prohibition on the expansion of foreign ownership in banking, as well as the freeze on the number of branches of foreign banks at their October 5, 1988 level, remains in effect. Those prohibitions could be waived pursuant to international accords, based on considerations of reciprocity or the national interest. However, no foreign bank has been authorized to enter Brazil under such a waiver.

The operations of previously established foreign banks were grandfathered, but are still subject to restrictions on expansion. Both foreign and domestic banks are subject to restrictions on branching. Domestic banks may add branches by acquiring other banks, while foreign banks are allowed only to acquire branches of other foreign banks. Foreign banks may relocate branches by closing one branch to open a new branch.

The inability of U.S. banks to add branches since 1988 has been an especially important disadvantage in Brazil because it effectively limits the ability of U.S. banks to profit from float, which has been a significant part of banking earnings in recent years. In addition, the prohibition on expansion extends to ATMs, so that a foreign bank would need to close an existing branch in order to open a new ATM.

Minimum requirements for paid-in capital and net worth of foreign banks are twice those for domestic banks. After establishment, permission to expand existing operations or conduct new

activities may be denied by the Central Bank of Brazil, or authorized on terms and conditions less favorable than those applied to domestic banks.

As of August 17, 1994, the prohibition on the establishment of an ATM network by foreign banks was lifted. However, official approval is still required to do so, and there is no experience yet on how the procedures will work. Foreign banks may currently share ATM networks with other banks on a minority basis. It is important to note, however, that the August 1994 liberalization did not affect the treatment of foreign-controlled ATMs under the 1988 Constitution. That is, expansion of the total number of ATMs controlled by foreigners continued to be restricted. Another change in Brazilian regulations that was favorable for U.S. and other foreign banks was the establishment of multiple banks. Prior to this, banks needed special approval to operate in each of the various financial sectors. The advent of multiple banking broadened the range of activities that banks can engage in without obtaining specific approval. As noted above, most foreign banks have taken advantage of this change.

BRAZIL

SECURITIES

SUMMARY

Brazil's securities markets are regulated by the National Monetary Council, through the Brazilian Securities Exchange Commission, as well as the Central Bank of Brazil.

Due to massive problems with inflation and government budget deficits over a period of several years, a large supply of Brazilian government paper is quite actively traded by financial institutions. The Sao Paolo Stock Exchange, the largest of Brazil's nine stock exchanges, has registered impressive gains in trade volume and share appreciation in recent years, but its market capitalization as a percentage of GDP remains relatively low, and its performance has been inconsistent. Furthermore, the market for new domestic issues has been and remains quite thin: few corporations raise capital through the Brazilian exchanges. Having obtained permission to offer securities and place commercial paper abroad, Brazilian firms have gravitated more towards international markets in order to raise capital on a cheaper and more flexible basis.

Free from segregation between banking and securities business, the primary participants in the Brazilian securities market are the multiple banks, followed by large public and private pension funds and mutual funds. (Other types of banks may conduct securities business through a subsidiary, after obtaining essentially pro forma approval from the National Monetary Council.) With respect to foreign participants, Brazil's new Constitution in 1988 barred all new entry of foreign securities and brokerage firms, but grandfathered foreign firms established prior to 1988. Foreign securities firms already established in Brazil may underwrite, broker, and trade in domestic securities, and hold seats on Brazilian stock exchanges. They face no other impediments. More recently, new firms have been entering the Brazilian securities market, primarily as minority partners in joint ventures with Brazilian companies.

Since 1991, the government has been changing regulations to facilitate foreign portfolio investment in Brazil. Particularly important has been the 1991 approval of Annex IV, which opened Brazil's stock market significantly by permitting foreign institutional investors to invest directly through managed portfolios, and eliminating the minimum holding period before repatriation. Since implementation of Annex IV, foreign participation in the Brazilian stock market has skyrocketed from $386 million in 1991 to $5.8 billion in 1993.

DESCRIPTION OF THE MARKET

Regulation

Brazil's National Monetary Council, formally chaired by the Finance Minister, is the highest federal government regulatory body that oversees Brazil's securities markets. The council, of which the Central Bank President is a member, supervises the securities industry through the Brazilian Securities Exchange Commission (CVM), which is the equivalent of the U.S. Securities and Exchange Commission. The CVM has a smaller staff, administered by a president and four directors. The CVM's staff is appointed by the president and is subordinate to the Finance Minister; the Central Bank is the primary executing authority of council decisions.

Law 6385, enacted in 1976, empowers the CVM to supervise the activities and services of the securities markets and impose fines to punish infractions. The CVM regulates stock exchanges, brokers and mutual funds, and also supervises pension fund and leasing company activity in the stock markets. CVM authorization is required before securities exchanges can start operations. Foreigners cannot participate directly in the Brazilian securities market; they can only participate through a management company[1] authorized by the CVM.

The Central Bank of Brazil also regulates domestic securities products, pension funds and leasing companies, and investment abroad by Brazilian individuals and firms.

Brazilian financial rules and regulations are not fully transparent, and regulatory authorities, primarily the Central Bank, have broad discretionary authority. They can, and have, exercised this authority in occasionally arbitrary fashion. For example, certain foreign financial institutions have been able to establish and expand their operations despite Constitutional restrictions.

Capital Formation: Instruments and Exchanges

High inflation and persistent government budget deficits in Brazil over the past several years have left a large supply of Brazilian government paper in the hands of the private sector. As a result, Brazilian government paper is the primary instrument traded by financial institutions. Most of this paper has an original maturity of less than two years, and is popular for its liquidity and positive real return. Investors participate through government-certified dealers (primarily banks, both domestic and foreign) in the Central Bank's primary government paper market. The most important of the government's debt instruments are National Treasury Notes (NTN), Central Bank Bonds (BBC), National Treasury Financial Letters (LFT), and National Treasury

[1] A management company is any institution through which the investment is channeled, such as a corretora, distribudora, multiple bank, et cetera.

Letters (LTN). The instruments vary by their maturity, method of exchange rate correction, and indexation to inflation.

Brazil has nine stock exchanges, listing a total of 829 companies. The largest, representing 80 percent of total trading volume at the end of March 1994, is the Sao Paulo Stock Exchange (BOVESPA), which trades in stocks, including stock options and futures. The Rio de Janeiro Stock Exchange (IBV), accounts for 19 percent of total volume. The seven other regional exchanges have a negligible presence, and are linked electronically with the Rio exchange through a network known as SENN. A separate Futures and Commodities Market (BMF) trades in futures, options, and debentures. Futures trading includes gold, exchange rates, the Sao Paulo Exchange index (IBOVESPA), overnight interest rates, coffee, and cattle.

BOVESPA listed 552 companies in 1993, up from 426 in 1980. Nationally, the trend has been to delist on stock exchanges (618 in 1980 to 582 in 1993). BOVESPA's popularity has been explained in part by the shift in activity from Rio de Janeiro to Sao Paolo; negative or stagnant economic growth explains the national trend.

Daily turnover on the various stock exchanges also provides a rough comparison of the relative sizes of these exchanges.

Stock Exchanges (volume in dollars on March 30, 1994)	
Sao Paulo	256,621,208
Rio de Janeiro	59,317,461
Belo Horizonte	1,579,239
Porto Alegre	979,707
Parana	594,619
Bahia	31,874
Pernambuco	30,592
Santos	4,663
Ceara	0

Although share appreciation on Brazil's largest exchange, BOVESPA, has been quite steep over the past few years ($95 billion in December 1993 versus $15 billion in December 1990), market capitalization as a percentage of GDP remains relatively low, at 25 percent (compared with 45 percent in Mexico and 40 percent in South Korea). Furthermore, while overall performance has been impressive, performance from year to year has been highly erratic, declining 70 percent

in 1990, growing over 300 percent in 1991, declining 4 percent in 1992, and growing again by 110 percent in 1993 in U.S. dollar terms.

Few corporations raise capital through the Brazilian exchanges due to the considerable expense involved. In 1993, only $841 million was raised in the primary market, generated through 24 new issues (compared with $523 million in 1988). Efforts to expand opportunities for capital formation are ongoing: bond trading began in 1991 to assist companies in raising working capital, and 135 issues were placed in the market in 1993, valued at $3.8 billion. In addition, Brazilian securities authorities are trying to establish an over-the-counter (OTC) market for securities listed by small and medium-sized businesses. Brazilian firms are allowed to offer securities on international capital markets and obtained permission to place commercial paper in international markets in mid-1990. The latter has been widely used, as it is a much cheaper source of financing compared with the high real interest rates and short term loans available domestically.

Trading volume in the secondary market in 1993 was $39.6 billion. Equity trading on Brazilian exchanges is highly concentrated in a very few stocks. Although 829 companies were listed on Brazilian exchanges in March 1994, the telecommunications parastatal, Telebras, accounted for over 50 percent of the volume traded on the exchanges, and the electric utility parastatal, Electrobras, almost 20 percent. The government-controlled mining/industrial conglomerate, Companhia Vale do Rio Doce, and the state petroleum company, Petrobras, account for another 5 percent of the trading volume.

Participants

Unlike the United States, Brazil has not segregated participation in banking and securities markets. In fact, the primary players in the Brazilian securities markets are the multiple banks[2], both domestic and foreign, which account for 44 percent of trading volume. Other major participants include the large public and private pension funds and mutual funds. Foreign investors as a group account for 20 percent of trading volume. Individual investors represent a very small percentage.

[2] As discussed in more detail in the banking chapter, multiple banks are authorized to engage in a broad variety of financial services, such as investment and commercial banking, stockbroking, and leasing.

Securities Held by the Public (in billions of dollars, as of December 1993)	
Government Paper	42.1
Central Banks	9.1
Treasury Notes	33.0
Certificates of Deposits	33.2
Fixed Income Mutual Funds	3.5
Mutual Funds	2.3
Fixed Application Funds	6.0
Commodities funds	7.2

Brazil has two classes of stockbrokers: corretoras and distribuidoras. Corretoras are securities firms that hold seats on the exchanges. The distribuidoras accept trading orders from investors and must deal indirectly with the exchanges through the corretoras. A seat on an exchange must be purchased in order to establish a brokerage firm. Both foreign and domestic firms may function as either class, since legally, any firm already established in Brazil may purchase a seat on the exchange. Trading volume is widely distributed among the more than 170 brokerage operations registered with the Brazilian Securities Commission. The top 40 brokers in March 1994 accounted for 71 percent of total trading.

Volume of Trading of Top 10 Corretoras on Sao Paulo Exchange (millions of U.S. dollars, as of March 1994)	
Company	Trading Volume
Garantia	729.8
Tendencia	541.6
Itau	412.3
Bancocidade	363.0
Hedging-Grifo	344.7
Souza Barros	335.0
Prosper	314.3
Guilder	305.5
Crefisul	297.1
Sinal	292.3

Fund Management

Brazilian mutual funds are similar in structure to U.S. funds, but are often operated by the largest banks, and sales to customers are conducted through the operating bank or firm. There were 83 mutual funds in Brazil in December 1993.

Fixed-income mutual funds invest primarily in certificates of deposits and debentures. Again they are mainly operated by the large banks. There were 84 such funds in December 1993. Customers can purchase these funds by telephone directly from the operating bank.

Financial Investment Funds (FAF) have replaced the Short-Term Government Paper funds. They were designed to allow small investors a relatively safe and liquid savings instrument. There are 83 operating in Brazil. These funds hold a minimum of 45 percent of their portfolios in federal public securities (National Treasury and Central Bank paper) and some low-yielding, government-directed investments.

Commodities Mutual Funds are the most popular funds in Brazil today. There are 194 Commodities Funds, managed by domestic and foreign banks. Commodity fund portfolios are limited to 60 percent of public or private pre-fixed securities and must have a minimum of 25 percent of agriculturally related private securities.

The 1988 Constitutional restrictions prohibiting the entry or expansion of foreign banks applies as well to foreign securities firms. As with the banks, foreign securities firms already established at the time were grandfathered. Despite these restrictions, foreign securities firms have been entering Brazil in recent years as partners of Brazilian firms. A constitutional amendment to eliminate the distinction between foreign and national capital failed to gain sufficient support during the constitutional review process that ended May 31, 1994. A complementary law regulating financial institutions, which could also open up the market to foreign firms, has been languishing in the Brazilian Congress for years. The recently elected president, who will assume office January 1, 1995, supports foreign investment. Government of Brazil authorities can be expected to proceed further in opening Brazil's financial market.

Capital Controls and Foreign Investment

Foreign portfolio investment is subject to the exchange control system established by the Foreign Capital Law. Portfolio investment by foreigners in fixed-income instruments is restricted to a particular class of fixed-income funds; a financial transactions tax of 5 percent is imposed. Foreign investors may make indirect portfolio investments ($1,000 minimum) in Brazilian equities by acquiring shares in a Brazilian investment company quoted on one of the Brazilian stock exchanges. Although the transaction must be registered with the Central Bank, it can be repatriated without restriction. Portfolio investment is also possible through the purchase ($5000 minimum) of quotas of the Investment Fund-Foreign Capital, which can be repatriated freely. (Foreign investment other than portfolio investment in Brazil is classified for purposes of

registration as direct investments or loans. If the foreign capital does not constitute part of the corporation's capital directly subject to the risk of operations, then it is considered to be a loan.)

Brazilian firms may hold equity shares in foreign companies, subject to regulation by the Central Bank. Under current regulations, individuals and firms are allowed to purchase stocks on exchanges in other Mercosur countries (Uruguay, Argentina, and Paraguay) subject to various controls and limitations. Firms may send up to $5 million per year abroad to related companies to pay for offices, service centers, and representatives without previous Central Bank approval (but the transaction must be communicated to the Central Bank). Firms may also send more than $1 million abroad provided that the bank carrying out the transaction consults the Central Bank regional office 30 days in advance and the Central Bank has no objection. Upon closing business activities abroad, a Brazilian firm is required to repatriate capital and any receipts. Economic mismanagement and high inflation have fomented significant capital flight from Brazil in the past decade, and despite the imposition of capital controls, additional investment abroad continues to occur.

Brazil's regime of capital controls is presently in a state of flux. Starting in 1991, a number of regulations were changed to facilitate foreign portfolio investment in Brazil. In order to provide additional investment vehicles, Brazilian authorities in mid-1991 permitted foreign investors to invest in Brazil via American and international depositary receipts (ADRs and GDRs), securities issued abroad based upon Brazilian shares deposited with a financial fiduciary institution. The National Monetary Council approved Annex IV (CMN Resolution 1832 of 1991 amending Resolution 1289 of 1987), opening the stock market significantly by permitting foreign institutional investors to invest directly through managed portfolios, and eliminating the minimum holding period before repatriation. (Individual foreign investors and companies domiciled abroad are still prohibited from entering the Brazilian stock market, however.) In addition, Annex IV permitted establishment of omnibus accounts to incorporate sub-accounts of other institutional investors. (Omnibus accounts permit foreign investors to set up individual accounts, enabling them to circumvent restrictions against foreign individual investors directly investing in Brazilian securities markets.) Rules allowing swaps and hedges were established in 1992.

As of December 1993, the government has authorized eight vehicles for foreign portfolio investment:

Foreign Capital Investment Companies
Foreign Capital Investment Funds
Foreign Capital Securities Portfolios
Managed Portfolios - Direct Investment
Debt/Equity Conversion Funds
Privatization Mutual Funds
Venture Capital Companies

Foreign Capital Fixed Income Fund

Resolution 1935 of June 30, 1992, authorized foreign institutional investors to trade on the futures and commodities market futures and options contracts, based on stock indices, interest rates, and exchange rates.

Since implementation of Annex IV, foreign participation in the Brazilian market has increased from $386 million in 1991 to $5.8 billion in 1993. The president of BOVESPA credits foreign capital inflows for pushing daily trading volume on the exchange from $25 million in 1991 to over $250 million today. By December 1993, five foreign investment companies, 75 open-end investment funds, one closed-end fund, 1,293 Annex IV foreign investors were registered with the CVM. This latter category includes 129 banks, 111 brokers, two non-profit institutions, and 107 trusts and funds. By origin, Annex IV investment is 31 percent North American, 31 percent Central American, 24 percent European, 12 percent South American, and 2 percent Asian. Eighty percent of Annex IV investment valued at $10.1 billion in December 1993 is in stocks and 18.5 percent is in bonds.

Prior to 1993, foreign investors were charged a 25 percent withholding tax on dividend remittances. In an attempt to attract more foreign capital, the tax was reduced to 15 percent in 1992. However, with large amounts of foreign capital continuing to enter Brazil, the Central Bank's ability to control the monetary base has been diminished. In order to discourage lending for consumer credit and stem purchases of government paper, the National Monetary Council raised the tax on loans (i.e., Brazilian companies issuing bonds overseas) from 3 percent to 7 percent, on investment in fixed income funds from 5 percent to 9 percent, and on stock purchases to 1 percent in October 1994.

Foreign Participation in Financial Markets
(billions of dollars)

	19990	1991	1992	1993
Total	5.3	11.6	17.8	32.7
Investment	.6	1.5	5.2	15.9
Portfolio	.2	.8	3.9	14.1
Direct	.5	.7	1.3	1.0
Loans	1.0	4.4	8.0	11.0
Commercial Paper	.6	1.8	1.2	.3
Bonds/Export Notes	.1	1.5	4.8	7.6
Renewals	0.0	.3	.1	1.1
Other	.4	.8	1.9	2.0
MDB Financing	2.8	4.2	3.1	3.3
Registered	.8	.9	.4	.4
Authorized	2.1	3.3	2.6	2.8
Leasing	.6	1.5	1.2	1.4
Export Pre-pay	0.0	.1	1.1	1.4

U.S. PRESENCE IN THE MARKET

Due to high internal interest rates, U.S. securities and brokerage firms have taken lead roles in assisting Brazilian borrowers in gaining access to foreign capital markets.

Several U.S. securities firms have minority interests in joint ventures with Brazilian companies. In addition, Salomon Brothers has been able to gain a majority interest in a Brazilian securities firm by buying the shares of its Brazilian partners.

With respect to accessing foreign capital, U.S. securities firms have been active in underwriting international issues by Brazilian companies, which have increased sharply since 1990. U.S. firms dominate Brazilian borrowing in the Eurobond market: of the top ten institutions in 1993 five were U.S. firms, accounting for more than 40 percent of volume; Citibank alone accounted for nearly 13 percent Brazil's Eurobond issues last year. In an attempt to restore its commercial credit rating, the government of Brazil has chosen Goldman Sachs to manage its return to international bond markets. However, as part of its economic stabilization plan, the Brazilian government limited for 90 days the issuance of bonds in foreign markets by Brazilian states and municipalities and publicly owned enterprises, effective July 1, 1994.

U.S. (and other foreign) banks have also been active in Brazil's securities markets. Citibank has its own brokerage operation and a majority interest in Crefisul, the ninth largest brokerage. U.S. and other foreign banks are represented among foreign investment stock funds in Brazil. The top 10 funds, accounting for 80 percent of foreign investment fund activity, in descending order are Chase Manhattan (U.S.), Banco Garantia, Bank of Boston (U.S.), Banco Itau, Unibanco, Economico, HKB (Hong Kong), BFB (France), and Banco Pactual.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since 1988, new entry of foreign brokers and securities firms has been barred. Only those foreign securities firms already established in Brazil may underwrite, broker, and trade in domestic securities, and hold seats on Brazilian exchanges. Foreign firms established in Brazil face no impediments, provided such products are duly registered with and regulated by the Central Bank and/or the CVM. Although previously no firm, foreign or domestic, had been permitted to deal in foreign securities, in September 1994 the CVM authorized Brazilians, through foreign and domestic banks, to invest in securities traded in international markets, with the proviso that 60 percent of the investment must be in Brazilian external debt.

Foreign firms may engage in fund management activities, although they may not sell foreign mutual funds to local investors. Foreign capital investment into Brazil remain subject to a number of exchange controls and other limitations on access, although repatriation is not restricted.

By drawing a distinction between national and foreign capital and by restricting foreign investment in a number of sectors, including financial institutions, the new Constitution adopted in 1988 denies freedom of investor choice to foreign investors. Brazilian authorities do recognize the country's need for foreign capital investment, however, and in practice, have tended to be as flexible as possible in facilitating the activities of foreign investors.

CHILE

BANKING

SUMMARY

As of early 1994, 38 banks and consumer finance companies were operating in Chile. The one state-owned bank, the Banco del Estado, is Chile's largest bank, accounting for 15 percent of loans and 19 percent of deposits. Private banks handle nearly all corporate business within the banking sector. Four "financieras," roughly equivalent to consumer finance companies, concentrate on consumer business and are not allowed to offer checking accounts or handle international business.

Vigorous economic growth in recent years has strengthened bank profits. However, Chilean authorities consider Chile "overbanked" and have not allowed new banks to enter the market since the financial sector crisis in the early 1980s, except by purchasing existing banks. This restriction applies to domestic as well as foreign firms. In addition, there are restrictions on both domestic and foreign banks' ability to enter several rapidly growing areas of business, including securities brokerage, pension fund management, factoring, and leasing.

The banking sector is regulated by the Superintendency of Banks and Financial Institutions, an agency that reports to the Finance Minister. The Central Bank, in conducting monetary and exchange rate policy, also regulates bank operations.

As of late 1993, eight U.S. banks had 43 branches in Chile. The eight banks with branches accounted for around 5 percent of deposits and loans in the banking system. U.S. banks generally focus on corporate rather than individual business.

Foreign banks are allowed to establish either as branches or subsidiaries, although the Bank Superintendency appears to prefer that foreign banks set up branches. Foreign banks operating in Chile are guaranteed nondiscriminatory treatment by a 1960 law and Chile's foreign investment law (Decree Law 600). Foreign banks can engage in the same range of activities permitted domestic banks. The only instance of discriminatory treatment, an alternative minimum tax on branches of foreign banks, was repealed in 1993. However, lending limits are based on a foreign branch's local capitalization, rather than the worldwide capital of its parent.

As of end-1993, one private Chilean bank, the Banco de Chile, had a branch office in New York and had received U.S. approval to open a state agency in Miami. Another private bank, the Banco de Santiago, had a representative office in the United States.

DESCRIPTION OF THE MARKET

Structure of the Market

As of early 1994, 38 banks were operating in Chile; total banking system assets were $47.3 billion. Domestic Chilean banks have varying patterns of ownership. The one state-owned bank, the Banco del Estado, is Chile's largest bank, accounting for 15 percent of loans and 19 percent of deposits. Some of the 13 private Chilean banks are controlled by Chilean families with other commercial and industrial interests. Others are owned in part by banks or firms from the United Kingdom, France, Italy, the Netherlands, Canada, and Spain. Shares of most private Chilean banks are traded on Chilean stock exchanges, and ownership of the largest private bank, the Banco de Chile, is spread among many Chilean stockholders. The 20 foreign banks operating in Chile include eight U.S. banks (43 branches) and branches or subsidiaries of banks from Spain, Brazil, Argentina, the Netherlands, France, Japan, and Hong Kong.

The Banco del Estado concentrates on providing services to the public sector and savings accounts to small individual savers. It is not seen as a major direct competitor to the commercial banking system. Private banks handle nearly all corporate business within the banking sector. Four "financieras," roughly equivalent to consumer finance companies, concentrate on consumer business and are not allowed to offer checking accounts or handle international business. As of end-1993, one Chilean bank, the Banco de Chile, had an office in New York and had received U.S. approval to open a state agency in Miami. Another private bank, the Banco de Santiago, had a representative office in the United States.

Corporate lending is focused on medium-sized businesses. Until early 1994, banks were prohibited from lending more than 5 percent of their assets to a single customer, so firms wanting to borrow larger amounts resorted to international sources of finance. An early-1994 banking reform increased from 5 to 10 percent the maximum percentage of total assets that a bank can lend to a single borrower. This measure will improve the ability of banks to lend to larger borrowers.

Chile's rapid economic growth over the last decade has led to rising financial activity and healthy bank profits. However, the banking system has not fully overcome its crisis of the early 1980s. Nine Chilean private banks owe substantial debts to the Central Bank dating from its rescue of the financial system a decade ago.

Chilean authorities consider Chile "overbanked" and have not allowed new banks to enter the market since the crisis of the early 1980s. Foreign or domestic firms wishing to enter the Chilean market must purchase existing banks. Several foreign banks have entered the Chilean market in this way in recent years. The government has prevented both foreign and domestic banks from entering new areas of business such as securities brokerage, pension fund management, factoring, and leasing until a fixed schedule for repayment of this debt is in place.

For this and other reasons, banks are losing business to nonbank companies, some of which are owned by bank stockholders (including foreign banks), that offer financial services. The government is considering reforms to this prohibition, but any modifications will be predicated upon the government and the banking industry reaching an acceptable repayment program.

Distribution of Chilean Banking Sector Deposits and Loans

Type of Institution	Number of Firms	Number of Branches	Percent of Deposits	Percent of Assets
Domestic Private Banks	13	837	61.9	60.3
Banco del Estado	1	213	18.5	15.8
Foreign Banks*	20	167	15.6	21.2
of which U.S. Banks	(8)	(43)	(5.1)	(10.4)
Consumer Finance	4	134	4.0	2.7
Total	38	1,351	100.0	100.0

* At least 51 percent foreign ownership. Branch information is as of March 1994. All other figures are as of April 1994.

Source: Superintendency of Banks and Financial Institutions.

With the vigorous growth of recent years, loan quality has improved dramatically. As of end-1993, delinquent loans had declined to an all-time low of 0.8 percent of total loans.

Automatic teller machines are provided by a network of 23 private banks. As U.S. banks concentrate on corporate lending, most do not have ATMs and do not participate in the network. However, foreign banks are afforded the same treatment for offering ATM services as domestic institutions. In early 1994, the number of ATM cards in use was estimated at 1.1 million.

Bank credit cards are managed by a separate network of 13 private banks. As of September 1993, over 1.2 million credit cards of 19 different types were being used in Chile. The number of cards is estimated to have grown by 23 percent in 1993. Total 1993 spending using bank credit cards was estimated at $800 million. Retail stores make up a significant part of the credit card business, and a department store is actually Chile's largest issuer of credit cards (by number of cards).

Banks trade foreign exchange in the official foreign exchange market. Since mid-1992, banks and other local firms have been allowed to trade currency futures and options, and also foreign

currency interest rate futures and options. The volume of these transactions on the Santiago Stock Exchange is small; the off-exchange trading volume is not known.

Regulatory Structure

The banking sector is regulated by the Superintendency of Banks and Financial Institutions, an agency that reports to the Finance Minister. The Central Bank, in conducting monetary and exchange rate policy, also regulates bank operations. Banking legislation expected to be approved in 1995 will, among other things, implement the Basle capital adequacy standards. There are no restrictions on interest rates that banks can charge. The Central Bank and the Superintendency of Banks both regulate derivatives trading.

The Chilean government guarantees 90 percent of bank time deposits, for both domestic and foreign banks, up to approximately $3,000 per depositor. Holders of current (checking) accounts are given priority over all other creditors.

U.S. PRESENCE IN THE MARKET

Eight U.S. banks operate in Chile through 43 branches. Most U.S. banks have concentrated on corporate lending. In 1992, Chase Manhattan sold its individual accounts to the Chilean Banco A. Edwards. A few U.S. banks, however, have significant retail banking businesses. Several have established securities subsidiaries that have no formal connection to their Chilean banking branches.

In recent years, the Chilean bank operations of Chilean branches of U.S. banks in general have not been highly profitable compared to private Chilean banks. Two reasons are commonly cited for this. First, much of the corporate business generated by U.S. banks is booked offshore and is not reflected in the Chilean accounts of the U.S. branches. Second, U.S. banks generally show more dollar assets than obligations and more peso obligations than assets. Real peso appreciation, which has taken place in recent years, leads to losses. These losses of Chilean branches are balanced by corresponding gains of U.S. parent firms, which have balancing surpluses of dollar obligations and peso assets.

U.S. Commercial Banks' Share of the Chilean Market as of April 1994

Bank	Percent of Deposits	Percent of Assets
Citibank	2.1	2.9
Bank of Boston	0.9	2.0
Republic National Bank	0.5	0.7
Chase Manhattan	0.4	1.7
American Express	0.3	0.6
Bank of America	0.7	1.9
Chemical Bank	0.1	0.4
Continental Illinois	0.0	0.2
Total	5.0	10.4

Source: Superintendency of Banks and Financial Institutions

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Domestic or foreign firms wishing to enter the banking market must purchase existing banks, a course of action that has been taken by foreign and domestic firms in recent years. Although foreign banks are allowed to establish either as branches or subsidiaries, the Bank Superintendency appears to prefer branches because the legal liability of a foreign branch extends to the parent institution. All U.S. banks in Chile are considered branches by their home offices and Chilean law. However, they have the subsidiary-like characteristic of being subject to lending limits based on local capital.

In previous years, branches (but not subsidiaries) of foreign banks were subject to an alternative minimum tax, designed to prevent transfer pricing, of 0.26 percent of deposits irrespective of income. They were charged the higher of this figure or the tax normally due. The tax was eliminated in November 1993. Some U.S. firms had claimed that the tax was unconstitutional; their challenge to attempts to collect the tax in previous years is still in court.

Foreign banks are permitted the same range of activities as domestic banks, including issuance of credit cards and the offering of ATM services. Foreign banks can fund themselves through deposits as do domestic banks. As mentioned above, both foreign and domestic banks are restricted by law from engaging in new activities until a fixed schedule for repayment of the debts owed to the Central Bank from private Chilean banks is in place. However, banks can

establish securities subsidiaries that have no formal connection to their Chilean banking operations to carry out these activities.

Foreign banks can trade foreign exchange through the official exchange market. However, Chile retains some controls on international movement of capital, many of which are applied to outward flows from institutions. One measure discouraging inward flows, particularly of short-term capital, is a 30 percent reserve requirement on all credit inflows except direct supplier credits. Under this measure, firms are required to deposit 30 percent of the inflow in a non-interest-bearing reserve for one year, or pay the Central Bank a tax equivalent to the interest that would be foregone. These capital restrictions apply to domestic and foreign firms equally under the law, but their removal probably would benefit foreign, including U.S., banks disproportionately because foreign banks' international networks are stronger than those of Chilean banks. Foreign banks can fund themselves through deposits.

Chilean regulatory practices are generally transparent. U.S. bankers contacted for this report did not express any complaints about regulatory transparency.

CHILE

SECURITIES

SUMMARY

Chile has three securities exchanges, with the Santiago-based Bolsa de Comercio and the Bolsa Electrónica accounting for nearly all of the transactions. The exchanges trade equities, central bank debt, and corporate debt. Despite the rapid growth in equity prices and an associated rise in new stock issues, the market remains relatively concentrated and illiquid. Trading is focussed on the shares of only a few companies and daily trading volumes tend to be small.

There is no legal discrimination or restrictions against foreign securities firms wanting to operate in Chile's securities markets. However, foreign brokerage firms wishing to operate in the Chilean securities markets must establish Chilean subsidiaries — 100 percent ownership is permitted. As of early 1994, 10 foreign firms, including several from the United States, participated as brokers through their Chilean subsidiaries. U.S. firms can manage pension funds, mutual funds, and operate insurance companies in Chile.

The most important institutional investors in both the stock and the bond markets are Chile's rapidly growing private pension funds, which currently have over $20 billion in assets (38 percent of GDP).

Direct purchases of Chilean equities by U.S. investors is permitted, but economically discouraged by a requirement that foreign investors must maintain their Chilean investments for at least one year, and that they are liable for Chilean capital gains taxes. Chilean institutions and individuals face a variety of limitations in undertaking investments in foreign securities.

U.S. firms have participated in underwriting Chilean offshore securities issues (bonds and ADR issues).

DESCRIPTION OF THE MARKET

Chile has three stock exchanges, of which the Santiago Trading Exchange (Bolsa de Comercio) accounts for about 70 percent of turnover by value. As of early 1994, it was owned by 46 shareholders, including five subsidiaries of foreign firms. The second largest exchange is the Electronic Exchange (Bolsa de Valores Electrónica), which was founded in 1989. As of early 1994, this exchange had 37 brokers, 20 institutional investors, and a market share of 25 percent. The nation's oldest exchange, the Bolsa de Corredores, based in the port city of Valparaiso, handles only 2 percent of total turnover.

As of mid-1993, there were 75 full service brokerage houses. An additional 15 securities dealers traded fixed-income debt instruments only. Affiliates of Chilean banks had a market

share of over 50 percent through 11 securities brokers. About 16 percent of the market was being conducted by 10 foreign securities firms.

Securities houses can be either "corredores de bolsa" or "agentes de bolsa." The former must belong to a stock exchange, while the latter cannot trade on the exchanges. Foreign firms must belong to the former category.

The three exchanges trade primarily corporate equity, corporate bonds, nominal and inflation-adjusted Central Bank debt, and mortgage debt issued by banks. Interest rates on Central Bank and corporate bonds with maturities of over 30 days are adjusted for consumer price inflation, but 30-day Central Bank paper is expressed in nominal interest rates. The Bolsa de Comercio handles most of the country's stock activity and fixed-real-rate bonds, while the Bolsa Electrónica handles mostly short-term Central Bank paper. The Bolsa de Comercio runs a small futures market where futures of dollars and the blue-chip stock index are traded. New financial products must be approved by the Central Bank and/or the appropriate superintendency (of banks and financial institutions, or of securities and insurance). In addition, new products to be traded on securities exchanges must be approved by those exchanges.

The rapid economic growth of recent years and an increase in investor confidence have led to the dramatic increase in stock market activity in terms of volume, market capitalization, share value, and in the number of companies listed.

Trading Volume in Chilean Markets[1], 1992-1993
(billions of pesos, indexed to December 1993)

	1992	1993
Equities	884	1,191
Fixed-Real Rate Instrument	9,741	10,879
Short-Term Nominal Instrument	7,163	11,990
Currency	1,523	1,680
Futures/Other	16	14
Total	19,328	25,754
(Billions of Dollars)	(45)	(60)

[1] Bolsa de Comercio only
Source: Bolsa de Comercio

Combined Exchange Activity
All Exchanges, 1990-1993 [1]

	1990	1991	1992	1993
Yearly Trading Volume [2,3]	79	85	89	140[3]
Market Capitalization [2]	16	31	30	41[3]
Blue-Chip Percent Increase [4]	30	124	7	50
Number of Firms Listed	245	253	281	304
Number of Brokerage Houses	63	70	74	75

[1] In real terms.
[2] In billions of dollars indexed to December 1993.
[3] Includes all transactions, not just stock sales.
[4] Estimate.

Source: Superintendency of Securities and Insurance

Because share prices have increased so substantially in price in recent years, new equity offerings have far outpaced new issues of corporate bonds — even to the point of displacing corporate bonds as the primary means of raising capital directly. Chile's return to international creditworthiness has led several firms to sell bonds on international markets.

Stock and Bond Issuance, 1991-1993
(millions of dollars, indexed to December 1993)

	1991	1992	1993[1]
Stocks	345	526	1,133
Bonds[2]	771	189	270
Total	1,116	715	1,403

[1] Estimate.
[2] Domestic bonds only.
Source: Superintendency of Securities and Insurance.

Notwithstanding this growth, Chile's stock market still remains relatively concentrated and illiquid. Shares of the 10 most heavily traded companies, of which six were utility firms, accounted for over 45 percent of the market's capitalized value at the end of 1993. Trading in those shares accounted for 70 percent of total 1993 trading volume. In March 1994, average daily trading activity on the Bolsa de Comercio, which handles most of Chile's stock transactions, was only $17 million. The low rate of turnover makes prices highly volatile, especially when outside factors suddenly change a company's earnings prospects.

Foreign investment in Chilean shares has contributed to the increase in share prices and to the increase in blue-chip stock price/earnings ratios. However, most of the foreign share purchases have been targeted at the 14 Chilean firms whose shares are traded in the U.S. via American Depository Receipts (ADRs). The shares traded via ADRs include many of the market's most important companies. There also are 18 foreign capital investment funds that purchase shares in a variety of Chilean companies.

Prices of Chilean ADRs
(dollars)

Company	Placement Date	Placement Price	3/31/94 Price	Percent of Growth
CTC	7/90	15-1/8	89-1/4	490
Chilectra (OTC)	2/91	25	35	40
CCU (NASDAQ)	9/92	12-5/8	23-1/4	84
Madeco	5/93	15-1/8	29-1/4	93
Masisa	6/93	15-3/4	25-3/4	63
Soquimich	9/93	25-3/4	29-3/4	16
Enersis	10/93	21-3/8	18-1/4	-15
Cristales	1/94	23-7/8	18-3/4	-21

Source: Press articles

Institutional Investors

By far the largest institutional investors in Chile are Chile's private pension funds (AFPs) — managed by Administradores de Fondos de Pension (also known as AFPs). The AFPs were created in 1981 when the government-run pension system was privatized. Most adults then working switched to the private system, and all of those entering the labor force since that time have been required to contribute a fixed percentage of their wages to an AFP of their choice. As the economy has grown, and as new workers have entered the labor force, AFP assets have risen rapidly. As of September, 1994, AFP assets totaled about $20 billion. These funds are invested primarily in long-term bonds and the stock market.

Other institutional investors include insurance companies, mutual funds, and foreign investment capital funds. The 52 insurance companies, which had assets of some $4 billion as of end-1993, invest primarily in long-term Central Bank bonds. As of end-1993, mutual fund assets totalled $1.3 billion. Of the 49 mutual funds, 38 invest only in bonds and 11 invest in stocks and bonds.

The 18 foreign investment capital funds allow foreign buyers to trade Chilean stocks other than just those with ADRs. (U.S. investors are not prohibited from purchasing Chilean stocks directly, but foreign capital invested in Chile must be kept in the country for a minimum of one year.) The funds are registered under Chile's foreign investment law, D.L.600. The foreign investment funds allow U.S. investors to purchase shares in the U.S. in funds that trade Chilean stocks in the Chilean market. As of the end of 1993, assets of foreign investment funds totalled around $1.6 billion.

Assets of Institutional Investors (billions of dollars, end-1993)

	Assets (Est.)
Pension Funds	16.0
Insurance Companies	4.0
Mutual Funds	1.3
Foreign Investment Funds	1.6
Total	22.9

Source: AFP Superintendency, Bear Stearns

Regulation

Chile's securities markets are regulated by the Superintendency of Securities and Insurance (SVS). The SVS supervises corporations and other entities offering securities publicly, the stock exchanges, brokers, over-the-counter dealers, insurance companies, and mutual and investment funds. It requires quarterly reports and notification of any material facts by all entities offering securities. It signed an information exchange agreement with the U.S. Securities and Exchange Commission in 1993. The Superintendency of Banks and Financial Institutions supervises domestic banks, including trading in their stock, and AFPs are regulated by a third superintendency. The legal basis for formation and administration of joint stock corporations is Law 18,046 of 1981. A capital markets reform passed in early 1994 increased the variety of investment options available to the AFPs and tightened conflict-of-interest restrictions.

U.S. PRESENCE IN THE MARKET

U.S. firms, particularly affiliates of U.S. commercial banks, have a growing presence as stock and bond traders. As of December 1993, U.S.-owned securities firms had nearly 10 percent of the combined market, and several other U.S. firms owned partial stakes in, or were affiliated with, other brokers. Most of the U.S.-owned brokers are on the Bolsa Electronica, and only two are on the Bolsa de Comercio. None are on the smaller Valparaiso-based Bolsa de Corredores.

Among the institutional investors, a number of pension fund management companies, insurance companies, and foreign investment fund management companies are owned by U.S. firms. Six mutual funds, representing some 20 percent of the total value, are operated by Citicorp.

Over the last two years, a number of Chilean firms have raised capital abroad through ADR issuances and offshore bond placements. These forays into the international markets have generated advisory and underwriting fees for U.S. firms.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. brokerage firms can establish and operate in Chile according to the procedures of the foreign investment law, Decree Law 600, which is based on the principle of nondiscrimination. Nondiscriminatory treatment is also guaranteed in the Chilean constitution's Article 19. U.S. securities firms may be present in Chile, but only as subsidiaries.

There are no requirements concerning the employment of Chilean nationals or limits on the employment of foreign nationals. However, U.S. and other foreign securities firms wanting to trade stock on an exchange must purchase a seat. Recent transactions indicate that a seat on the Bolsa de Comercio is valued at over $1 million.

There is no obstacle to a U.S. firm establishing an AFP, as long as the AFP is a Chilean corporation (100 percent foreign ownership is allowed) and is registered with the Chilean AFP superintendency.

Purchases of foreign securities by Chilean residents (banks, pension funds, mutual funds, insurance firms) are limited according to regulations for each type of institution. The share of assets of pension funds that can be invested abroad in foreign securities is currently limited to 3 percent, but this total may rise to 6 percent in the next few years. Individuals may buy foreign securities, but they are not guaranteed authorization to buy dollars at the official interbank exchange rate (Central Bank authorization is required for foreign currency purchases on the interbank market for operations abroad, although a blanket authorization for certain types of operations is possible). Chilean individuals and firms wishing to make equity investments

abroad must register their investments with the Central Bank. Also, the Central Bank has placed limits that allow only relatively large and credit-worthy companies to issue stock in the United States via ADRs.

As for inward portfolio investment, government policies tend to discourage short-term portfolio investments in two ways. First, investors that use D.L. 600, the law establishing the procedure under which most foreign investments enter the country, must keep their capital in Chile for a minimum of one year. Second, 30 percent of all foreign credits (except supplier credits) must be placed in a non-interest-bearing reserve account with the Central Bank for one year. As a result, most U.S. investment in Chilean stocks is made either through ADRs traded on Wall Street or through U.S.-based foreign investment funds.

U.S. firms operating in the domestic market have not expressed concern over discriminatory treatment, although some have described the information requirements for beginning operations in Chile as onerous. Neither U.S. nor Chilean firms are typically invited to comment on proposed rule changes. However, foreign firms have characterized their communication with Chilean regulatory authorities as excellent.

COLOMBIA

BANKING

SUMMARY

At the end of 1993, the financial system in Colombia had total assets of $33.0 billion equivalent, three-fifths the size of the country's gross domestic product. Commercial banks dominated the financial market, accounting for 56 percent of the financial system's assets. As of year-end 1993, there were 28 commercial banks operating in Colombia with 3,100 offices located throughout the country. Savings and housing corporations (CAVs) comprised the second largest market segment, having 21 percent of the financial system assets. Financial corporations, national energy financial entities, commercial finance companies, mortgage banks, and cooperatives held the remainder.

Colombia's financial industry has undergone some significant regulatory and legal changes since its financial crisis in 1982, when a number of banks failed. At one point, 85 percent of the financial system was either owned or controlled by the government. By the late 1980s, the financial system began to show steady signs of improvement. A mandatory deposit insurance program was implemented in 1989. In 1989, the Basle Committee's capital framework was adopted by the Central Bank. In 1990 and 1991, with the enactment of various other legislative measures, the foundation for financial sector reform was laid. At the end of 1993, there were six commercial banks that still had some government ownership.

The representation of U.S. and other foreign banks in Colombia's financial system is relatively small. At the end of 1993, 10 commercial banks with more than 50 percent foreign ownership accounted for only 4.8 percent of the total assets of the financial system. There were two U.S. wholly-owned subsidiary banks in operation at the end of 1993, Citibank-Colombia (Citibank) and Banco Colombo America (Bank of America). Citibank had the largest foreign presence in the country with 19 branches and 70 percent of the foreign banking operations. Bank of America had a much lower profile, closing its only two sub-branches and concentrating its operations in the nation's capital.

U.S. banks can enter the Colombian market either through the acquisition of an existing bank or the establishment of a banking subsidiary. One hundred percent foreign ownership is permitted. A foreign bank must, however, establish a Colombian banking subsidiary before it can open branches. Once the subsidiary is established, it is treated as a Colombian entity. There are no constraints on foreign banks in funding their business activities by deposits, money market instruments, access to the Central Bank discount window, or bringing in capital from offshore via swaps. Foreign banks can engage in both retail and corporate banking, participate in ATM networks, issue credit cards and deal in foreign exchange. Foreign banks may participate in securities businesses through separately established securities subsidiaries.

DESCRIPTION OF THE MARKET

Structure of the Banking Market

The Colombian financial system is relatively large in comparison to the nation's gross domestic product (GDP). At the end of 1993, the deposits in all financial entities equalled 61 percent of the nation's GDP. Total assets of the 174 financial entities operating in Colombia at the end of 1993 amounted to 25.9 trillion Colombian pesos ($33.0 billion at the average 1993 exchange rate of 786.73 pesos to the dollar).

The legal and regulatory framework of the Colombian financial system is based on the principle of specialized and legally distinct financial subsectors. However, several large conglomerates control most of the financial system, including the Sarmiento Group, which owns Banco de Bogota; the Antioqueno Syndicate, which owns Banco Industrial Colombiano; the Santo Domingo Group, the Grupo Cafetero, and the Grupo Social.

At the end of 1993, the 28 commercial banks operating in Colombia, with more than 3,100 offices throughout the country, accounted for 56 percent of the total assets of the financial system. At the end of 1993, there were six commercial banks that had some form of government ownership. Collectively, they held assets of 6.0 trillion pesos ($7.6 billion), or 23 percent of the financial system's total assets. Early in 1994, the government of Colombia privatized one of the publicly owned banks (the Banco de Colombia) and work is currently underway to privatize two others (the Banco del Estado and the Banco Popular).

Commercial bank lending is concentrated in short-term loans, with occasional extension of maturities up to three years. In June 1993, 67 percent of the commercial banks' portfolios were concentrated in loans with maturities of less than 6 months, 11 percent with maturities of 6 to 12 months, and 22 percent with maturities of more than 12 months.

Savings and housing corporations (CAVs) accounted for 21 percent of the financial system's total assets at the end of 1993, forming the second-largest subsector of the financial system. These institutions are designed to capture savings and term funds for the financing of housing and other construction projects. They operate within the Unidad de Poder Adquisitivo Constante - Constant Purchasing Power Unit system (UPAC), which adjusts both deposit and lending rates to an inflation index defined by the government. The UPAC enables the CAVs to be more competitive than other financial entities in capturing funds, especially small deposits. CAVs are the major source of housing finance and may make mortgage loans up to 70 percent of the property value, for a maximum term of 15 years.

Other financial institutions participating in the financial market system with less significant exposures include: Financial Corporations with 9 percent of total assets; National Energy Financial entities with 6 percent; Commercial Finance Companies with 6 percent; Mortgage Banks (BCH) with 1 percent; and Cooperatives with 1 percent.

A Central Bank survey of commercial banks and financial corporations, conducted in late March 1994, revealed that the average interest rate paid on 90-day certificate of deposits was 25.2 percent. The average rate these same institutions charge borrowers during the same period was 36.2 percent.

Colombia has a free dollar market. Banks may engage in exchange transactions including those related to income from tourism, services rendered abroad, and remittances. However, major Colombian banks, and especially the two U.S.-owned banks in Colombia, are aware of the danger of criminals using their services for money laundering. Consequently they have established stringent controls on cash dollar transactions to preclude such activity.

Regulatory Structure

As defined by Colombia's 1991 Constitution, the Central Bank is Colombia's monetary, exchange and credit authority, and is responsible for maintaining the purchasing power of the Colombian peso. The Superintendency of Banks implements and oversees the application of Central Bank policies. It also establishes the bylaws for the internal operations of the financial sector, such as capital requirements, accounting and auditing systems, compliance requirements, and establishment of financial entities.

Since the financial crisis of 1982, which resulted in the failure of a number of banks, Colombia has modernized the legal and regulatory framework governing its banking and financial industry. The crisis was brought on primarily by inadequate bank capitalization, high-risk operations abroad, poor administration and low productivity. The government of Colombia responded to the crisis by nationalizing or intervening in banks comprising 85 percent of the financial system. By the late 1980s, the government of Colombia began reforming and liberalizing the financial system.

Mandatory deposit insurance for commercial banks and certain financial institution depositors was instituted in December 1989. Under the deposit insurance program, banks are required to pay, in four quarterly installments, an annual premium equal to 0.15 percent of total funds received from time deposits, checking accounts and the issuance and sale of certificate of deposits and bonds. If a bank fails, the insurance will cover 75 percent of all funds deposited by an individual or corporation up to a maximum amount of 10 million pesos (approximately $12,200). Thus, the maximum amount of deposit insurance payment a customer may receive is 7.5 million pesos (approximately $9,150).

In 1989, Colombia adopted a capital requirement framework similar to the Basle Committee on Banking Supervision. This requirement sets forth the revised capitalization standards for banking institutions. The Colombian regulations established five asset categories, each having its own risk rating. The Central Bank required that, effective July 1, 1990, risk-weighted assets could not exceed an amount equal to 12 times an institution's technical capital. Technical capital consists of tier I, or primary capital, and tier II, or secondary capital.

In 1990 and 1991, the enactment of various legislative measures laid the foundation for financial sector reform. Those laws redefined financial institutions, the framework within which they operate, and their expanded financial operations within the Colombian economy. In 1993, rules were established governing Colombian government regulation of the financial sector. As a consequence of the legislation mentioned above, and the much broader economic liberalization programs introduced by the administration of President Gaviria beginning in 1990, U.S. banks were granted greater latitude in their activities.

Banks must obtain the authorization of the Superintendency before they open their doors for business. Any transaction that results in an individual or corporation holding more than 10 percent of a financial institution's capital stock must obtain prior authorization from the Superintendency. The Superintendency bases its approval decision on the candidate's professional experience and education, financial solvency, character, and the likely effect the proposed transaction will have on the general welfare of the nation. Foreign investors receive the same treatment as Colombian nationals and are subject to the same ownership limitations.

In practice, the rates charged for bank lending are determined by market forces. However, there is a 55 percent "usury interest rate," set by the Superintendency, which sets the upper limits on interest rates. Interest rates above 55 percent are subject to penalty.

U.S. PRESENCE IN THE MARKET

The foreign presence in Colombia's financial system is relatively small. At the end of 1993, there were 10 private commercial banks with more than 50 percent foreign ownership, accounting for 4.8 percent of the total assets of Colombia's financial system.

Only two wholly owned U.S. subsidiary banks were operating in Colombia at the end of 1993: Citibank-Colombia (Citibank) and Banco Colombo Americano (Bank of America). Citibank-Colombia commenced operations in Colombia in 1929. It was wholly owned by its U.S. parent until 1977, when the Colombian government limited foreign holdings in banks to no more than 49 percent. Citibank was able to reacquire full ownership of its Colombian subsidiary in 1991.

Citibank-Colombia is the largest foreign bank in the country, accounting for approximately 70 percent of foreign banking operations. Citibank has its main offices in Bogota and operates 19

branch offices in major cities throughout the country. Operations are split between corporate banking and retail banking. Citibank was the seventh largest commercial bank operating in Colombia in 1993.

Bank of America commenced operations in Colombia in 1967, with the creation of the Banco Colombo Americano. Like Citibank-Colombia, Banco Colombo Americano was 100 percent owned by its U.S. parent, and like Citibank, it was forced to sell 51 percent of its shares to Colombian nationals in 1977. Bank of America reached an agreement with the Colombian government in 1986 which, inter alia, permitted it to regain full ownership of the bank.

Banco Colombo Americano has a lower profile than Citibank-Colombia. Banco Colombo Americano engages only in corporate banking activities, no retail banking services are offered. In keeping with Bank of America's corporate strategy, Banco Colombo Americano closed the two sub-branches it once had and now concentrates its operations in the nation's capital. The bank plans to rename itself "Bank of America" later this year, at about the same time that it relocates its offices from the center of Bogota to the city's northern suburbs.

The First National Bank of Boston recently requested permission from the Superintendency of Banks to open a wholly-owned subsidiary in Bogota. A favorable response to that request is expected soon.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks can enter the Colombian market either through the acquisition of an existing bank or the establishment of a banking subsidiary. A foreign bank, however, must establish a Colombian banking subsidiary before it can open sub-branches. One hundred percent foreign ownership is permitted for both acquired banks and established bank subsidiaries. There are no constraints on foreign banks in funding their business activities by either deposits, money market instruments, limitations on access to the Central Bank discount window, or bringing capital in from offshore via swaps. Once established, there is no difference in treatment between a subsidiary of a foreign bank and a locally owned bank. Foreign banks can engage in both retail and corporate banking, participate in ATM networks and issue credit cards, and deal in foreign exchange. Foreign banks may participate in securities businesses through separately established securities subsidiaries, though few have chosen to do so.

Assets of Colombia's Financial System
December 1993
(millions of Colombia pesos)

	Assets	Percent of Total
Banking System	14,465,161	55.8%
Private Commercial Banks	8,473,039	32.7%
Colombian Owned	5,544,655	21.4%
Foreign Owned (less than 50%)	1,694,347	6.5%
Foreign Owned (greater than 50%)	1,234,037	4.8%
Public Commercial Banks	5,992,122	23.1%
Official Banks	3,760,489	14.5%
Semi-Official Banks	2,231,633	8.6%
Savings & Housing Corporations	5,070,847	19.6%
CAV Corporations	4,561,086	17.6%
Central Corporations	509,761	2.0%
Financial Corporations	2,709,174	10.5%
Private	2,011,948	7.8%
Public	697,226	2.7%
National Energy Financial Entity	1,573,513	6.1%
Commercial Finance Companies	1,522,877	5.9%
Commercial Finance Companies	1,314,334	5.1%
Leasing Companies	208,543	0.8%
BCH (Mortgage Bank) Commercial Branch	388,817	1.5%
Cooperatives	191,897	0.7%
Total Assets	25,922,286	100.00%

Source: Colombian Banking Association

Assets of Colombia's Financial System
December 1993
(millions of Colombia pesos)

	Liabilities	Percent of Total
Banking System	12,739,948	56.0
Private Commercial Banks	7,227,880	31.8
Colombian Owned	4,709,888	20.7
Foreign Owned (less than 50%)	1,458,340	6.4
Foreign Owned (greater than 50%)	1,059,652	4.7
Public Commercial Banks	5,512,068	24.2
Official Banks	3,449,092	15.2
Semi-Official Banks	2,062,976	9.1
Savings & Housing Corporations	4,751,680	20.9
CAV Corporations	4,269,229	18.8
Central Corporations	482,451	2.1
Financial Corporations	2,030,892	8.9
Private	1,570,850	6.9
Public	460,042	2.0
National Energy Financial Entity	1,409,588	6.2
Commercial Finance Companies	1,327,278	5.8
Commercial Finance Companies	1,160,340	5.1
Leasing Companies	166,938	0.7
BCH (Mortgage Bank) Commercial Branch	344,182	1.5
Cooperatives	151,134	0.7
Total Liabilities	22,754,702	100.00

Source: Colombian Banking Association

Equity Participation in Colombia's Banking System
1993

Bank	GOC*	Private Foreign	Private Columbian	Total
Bogota	0.0	0.0		100.0
Popular	94.4	0.0	100.0	100.0
Colombia	100.0	0.0	5.6	100.0
Cafetero	100.0	0.0	0.2	100.0
Commercial Antioqueno	0.0	0.0	0.0	100.0
Industrial Colombiano	0.0	0.0	100.0	100.0
Real De Colombia	0.0	96.2 (Brazil)	100.0	100.0
Citibank-Colombia	0.0	100.0 (US)	3.8	100.0
Anglo Colombiano	0.0	49.0 (UK)	0.0	100.0
Caja Agraria	99.8	0.0	51.0	100.0
Sudameris de Colombia	0.0	56.7 (France)		100.0
Ganadero	0.0	36.6 (Venez.)	43.3	100.0
De Credito	0.0	8.5 (Various)	63.4	100.0
Andino	0.0	1.4	91.4	100.0
Caldas	10.4	0.0	98.6	100.0
Colpatria	0.0	0.0	89.7	100.0
Del Estado	100.0	0.0	100.0	100.0
Union Colombiano	0.0	0.0	0.1	100.0
Del Occidente	0.0	0.0	100.0	100.0
Extebandes	0.0	0.0	100.0	100.0
Colombo Americano	0.0	100.0 (US)	100.0	100.0
Mercantil	0.0	100.0 (Venez.)	0.0	100.0
Tequendama	0.0	100.0 (Venez.)	0.0	100.0
Caja Social De Ahorros	0.0	0.0	100.0	100.0
Cooperativo De Colombia	0.0	0.0	100.0	100.0
Uconal	0.0	0.0	100.0	100.0
Latino De Colombia	0.0	75.0 (Venez.)	25.1	100.0
Diners	0.0	0.0	100.0	100.0

* Government of Colombia
Source: Colombian Banking Association

Foreign Banks Operating in Colombia
1993

Bank	Foreign Share (%)	Domestic Share (%) Private	Total %
Real De Colombia	96.2 (Brazil)	3.8	100.0
Citibank-Colombia	100.0 (U.S.)	0.0	100.0
Anglo Colombiano	49.0 (U.K.)	51.0	100.0
Sundameris De Columbia	56.7 (France)	43.3	100.0
De Credito	8.5 (Various)	91.4	100.0
Andino	1.3 (U.S.)	98.6	100.0
Colombo Americano	100.0 (U.S.)	0.0	100.0
Mercantil	100.0 (Venezuela)	0.0	100.0
Tequendama	100.0 (Venezuela)	0.0	100.0
Latino de Colombia	75.0 (Venezuela)	25.1	100.0

Source: Superintendency of Banks (1993)

According to the Superintendency of Banks, the assets of foreign banks in Colombia amounted to 1.2 trillion pesos, 8.5 percent of the total banking system and 4.8 percent of the Colombian financial system. The portfolios of foreign banks totaled 1,060 trillion pesos in 1993, equivalent to 7.3 percent of the Colombian banking portfolio and 4.1 percent of the complete financial system.

COLOMBIA

SECURITIES

SUMMARY

The Colombian securities market is in its fourth year of reform. Thus far, the results of the reforms have been mixed. Although trading activity is up significantly, the new issue markets for private sector fixed-income and equity instruments remain thin and apparently unattractive for issuers in comparison to bank credit. As such, Colombia's capital markets still have a long way to go before they can be considered fully developed.

Securities transactions take place on one of Colombia's three stock exchanges. Government paper is the predominant instrument traded. There is no futures market other than a very small one in agricultural products. However, the government is studying the possibility of developing hedging contracts. The markets are regulated by the Supervalores, which is answerable to the Ministry of Finance. The three exchanges are self-regulating within guidelines set by the Supervalores.

Colombia still retains a number of restrictions on foreign investment. Acquisition by nonresidents of more than 10 percent of a private company is subject to prior approval by the Stock Exchange Commission and the SuperBancaria. Access by residents to foreign securities is subject to a ceiling. And although Colombian firms may issue securities on the international market, issuance is subject to certain qualifications. U.S. firms have participated in these issues as underwriters.

There are no legal constraints on the establishment of securities firms in any form (both branches and subsidiaries are permitted). Foreign firms may purchase seats on any of the Colombian exchanges without restriction.

Only one U.S. firm active in the securities business has established a presence in Colombia. It reports no instances of discrimination in conducting its operations.

DESCRIPTION OF THE MARKET

Stock Exchanges

The Colombian securities market consists of three stock exchanges. The oldest and largest with 35 member brokers and 85 listed companies is the Bolsa de Bogota, founded in 1929. Cali's Bolsa de Occidente, founded in 1987, has 17 member brokers and 120 listed companies. The Bolsa de Medellin, with 29 member brokers and 169 listed companies, dates from 1961.

Although the Colombian securities market is small by developed country standards, it has enjoyed high rates of growth since various reforms were made in 1990. Total trading volume in 1992 was 85 percent higher in nominal terms than it was in 1991, and trading volume in 1993 was 69 percent higher than in 1992.

Collectively, the three exchanges reported total trading volume of 10.576 trillion pesos ($13.4 billion) in 1993. The Bogota Exchange accounted for 62 percent of the market, the Occidente followed with 22 percent, and the Medellin exchange accounted for the remaining 15 percent. The Bogota exchange estimates market capitalization of its listed companies at $500 million.

Trading, as well as underwriting, tends to be dominated by government paper. Transactions in government securities accounted for 64 percent of total operations on the Bogota Exchange in 1993, 47 percent on the Occidente Exchange, and 59 percent on the Medellin Exchange. Conversely, equities issued by private companies make up only a small percentage of the securities market. In 1993, just 6.7 percent of total trading volume involved equities. Nevertheless, that figure was 45 percent above the volume of stocks traded in 1992. Shares listed on any of Colombia's three exchanges must be traded on those exchanges. Shares not listed on the exchanges may be transacted on a person-to-person basis.

Public and private bonds accounted for 10.6 percent of total securities market trading activity in 1993, an increase of 79 percent over the total of 1992.

Foreigners may freely purchase seats on any of Colombia's three exchanges. Two foreign firms, Venezuela's Inverunion and Citicorp (U.S.), each have a seat on the Bogota Exchange. To obtain a seat, a broker must either buy a seat from a current holder or obtain a vacant seat. Of the 40 seats available on the Bogota Exchange, four are currently vacant at a cost of roughly $850,000 for each seat.

While not uniquely a problem for foreign firms, technical problems related to communicating quickly with clients sometimes hamper brokerage activities. The existing communication network does not permit brokers immediate point-to-point communication with their foreign clients. Given the nature of their business, foreign firms sometimes require up to two weeks to clear a transaction, considerably more than the five days that market rules allow. The delay can subject the firm to sanctions.

Market Regulation

The Superintendency of Securities (Supervalores), which is answerable to the Ministry of Finance, regulates Colombia's securities markets. It oversees the regulation of market intermediaries, brokers' fees, and the financial disclosure documents of listed companies. The Superintendency of Banks assumes some of the functions of Supervalores in overseeing the issuance and purchase of stocks by banks and pension funds.

Supervalores has promulgated regulations aimed at ensuring transparency and honesty in the marketplace, rules addressing the registration of shares, processing of orders, and guidelines governing the broker-client relationship. Most notable are the recent requirements for standardized prospectuses, standardized financial reports, and standardized accounting procedures. Listed companies must present quarterly financial disclosures and annual, externally audited financial statements.

The exchanges are self-regulating within the guidelines set by the Supervalores. The exchanges set admission policies, monitor transactions, conduct audits of brokerage activities, and enforce rules through their disciplinary bodies. Complaints typically involve routine matters like a failure to settle a transaction within a fixed period of time.

Nevertheless, enforcement is less diligent than in the United States. When procedures and enforcement fail, the exchanges draw on funds that they maintain from broker contributions to cover such damages. Insider trading, though prohibited, seems to evoke little outcry. Sanctions have been rare, and preventive measures, such as "Chinese Walls," are non-existent. Some of the more flagrant violations have been addressed. However, one firm was suspended from the exchange for buying another firm after it had participated in the latter's valuation.

Other institutions that police the exchanges include the National Registry of Stocks, the Central Depository of Stocks, and the Centralized Depository of Stocks of Colombia (Deceval). The National Registry is maintained by the Supervalores to inscribe market intermediaries and listed companies. The Central Depository and Deceval ensure smooth transactions by providing a central holding place for stocks.

While there are no explicit restrictions against the introduction of new securities products, securities instruments that are new to the Colombian market must be approved first by the Superintendent of Banking, which ensures that certain accounting and auditing systems are in place and that capital requirements are being met. Futures markets do not yet exist in Colombia, except for a relatively small amount of trading in agricultural futures contracts. The Superintendent of Banking is currently working with Citibank Colombia, leasing companies, housing loan corporations, and other commercial banks to establish bylaws to regulate futures markets in new securities, which are expected to appear later this year.

Recent Developments

During the 1980s, trading volumes on the three exchanges were negligible. Partly this was due to Colombia's major companies being family-owned enterprises and closed to outsiders; partly it was due to the legacy of the collapse in stock prices in 1984; and partly it was due to a high corporate tax burden and double taxation on corporate earnings. The three exchanges attracted relatively few investors, and all three experienced the volatility often associated with small markets.

To dampen volatility and thus minimize investor apprehension, the Bogota Exchange now suspends trading in a company for 30 minutes if the price of a stock falls by 15 percent. Should the decline persist, and involve 0.01 percent of the company's shares, trading in the stock will be suspended for two days. Afterwards, the stock can advance by up to 200 percent, or decline by 25 percent, before a further suspension is imposed.

Since 1990, reforms have been made in the tax area to induce greater investor interest. There is no capital gains tax. The government eliminated the double taxation of dividends. And the tax on patrimony was eliminated to encourage stock investments.

In addition, the exchanges introduced computerized trading systems. Although Occidente currently has the most modern system, the Bogota Exchange is likely to preserve its dominance because of its size and expertise in specialty services. Competition among the three exchanges results in ongoing innovation and experiments with new services and investments. The current surge in trading volume, for example, is due in part to a Cali innovation: the liberalization of brokers' fees. In allowing brokers to negotiate their fees with clients, a spirit of competition has broken out. Transaction volume has grown while brokers' profit margins have declined.

Finally, there have been several government initiatives designed to encourage investment in the market. Among the more important was social security reform and the establishment of mandatory IRA-like accounts for employees. The captive capital that will be created by these accounts will likely look toward the exchanges for investment opportunities.

Still, the Colombian equity market remains quite small. Firms in the private sector consistently prefer bank debt to equity when raising funds, while investors opt for public over private paper. Investors still recall the costly commercial bank collapse and the drastic fall in stock prices in 1984, which adversely affected small private investors. Many of Colombia's larger firms are dominated by family interests reluctant to give up or part with operational control. Some stocks are issued only in private offerings to pre-selected buyers. And to some degree the stock market still matches its reputation: only 35 of the 85 companies listed on the Bogota Exchange are traded regularly.

Future Goals

Colombia is conscious of the importance of foreign investment. The changes introduced in the fiscal, labor, exchange, financial, and foreign investment codes are aimed at attracting foreign investors. The government is working on the creation of an over-the-counter market to allow more than 10,000 existing companies to trade their stocks through the stock exchange (at present, only about 170 firms are registered at the stock exchange). Colombian authorities also are expanding the electronic transaction system that will link Colombia's three stock exchanges, brokers, and end-users. The system will be extended to the electronic management of shares, subscription rights and convertible debentures. The government also wants to expand the

activities of brokerage firms by allowing them to participate in investment banking, management of securities funds, offshore funds management, representation of foreign investors, and consulting.

Mutual Funds

Mutual funds now number 120, although their 1992 joint net worth was only 90.832 billion pesos ($115 million).

Foreign Investment

On August 24, 1994, the Colombian government issued a decree prohibiting foreigners from purchasing real estate in Colombia. Otherwise, the only significant restriction on foreign investment into Colombia is if a prospective buyer plans to acquire more than 10 percent of a company, then the authorities may prohibit the sale (the same prospective prohibition also applies to Colombian investors). This regulation is intended to detect and eliminate the flow of drug-related dollars into the market. Also, there are limitations regarding the purchase by foreigners of shares in the following sectors: 1) finance, in which share holdings of more than 10 percent must be approved by the Colombian Superintendency of Banks, a limitation also applicable to Colombian nationals; 2) hydrocarbons; 3) telecommunications; and 4) defense. In the last three sectors, all stock purchases require advance approval by the relevant ministry. There are no limitations on the purchase of public or private debt instruments.

The Colombian government has established Colombia Funds as vehicles to attract foreign portfolio investment. Thus far, the funds have attracted primarily Venezuelan and U.S. capital. They may be managed by both Colombian and foreign brokers and trust corporations. In June 1994, there were 86 Colombia Funds in existence, 55 of which were registered in the U.S. The total investment in all Colombia Funds as of June 1994 was $400 million, of which $195 million came from the U.S.-registered Colombian Funds. This total is less than 20 percent of the $2.167 billion the government has authorized. Most of the stocks held in the funds are Colombian blue-chip stocks, primarily in the construction, finance, and manufacturing sectors. Despite the disappointingly small flow of foreign money into the Colombia Funds, they are credited nevertheless for much of the growth seen in Colombia's exchanges in the past two years.

Access to Foreign Markets

Residents may access offshore markets as issuers of securities, subject to certain limitations. There is no limit on the issuance of common stocks, but the issuance of preferred stocks may not exceed 25 percent of the firm's legal reserves and paid-in capital. If debt instruments with maturities of three years or less are issued, the issuers must deposit 75 percent of the value of those instruments at the central bank. Colombian residents may access financial instruments offshore as investors up to a maximum of $500,000. As part of the August 24, 1994 decree, Colombian firms are restricted from selling commercial paper abroad.

U.S. PRESENCE IN THE MARKET

There is only one U.S. firm with a presence in Colombia's securities market, Citivalores, which is an affiliate of Citibank Colombia. While Citivalores is the only U.S. brokerage firm in Colombia, it ranks 14th (as measured by fee revenues) in a field of 35 brokerage houses doing business on the Bogota Exchange. A sister company of Citivalores, Cititrust, is a major securities depository company in Colombia holding in custody 97 percent of the $400 million that foreigners have invested in Colombian securities. Citibank has a strong presence in fixed-income securities (mostly government issues).

Altough no other U.S. brokerage house has established a physical presence in Colombia, several have come to Colombia in recent years to act as consultants to local firms. Lehman Brothers has participated indirectly in the Colombian market since the early 1990s. Salomon Brothers also has been in Colombia in recent years, as has Merrill Lynch, which has worked with the Colombian firm Financier del Valle. Bankers Trust also has been offering consultant services in Colombia.

The only other direct foreign presence in the Colombian securities market is Inerunion, from Venezuela.

U.S. firms have participated in underwriting offshore issues of Colombian firms. U.S. firms underwrote four securities offerings (depository receipts) by Colombian firms in 1993.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no legal constraints on establishment of securities firms either through acquisition, branching, or the establishment of subsidiaries. One hundred percent foreign ownership is permitted.

Foreign banks and securities firms may engage in fund management activities, but they must do so through separately established entities such as fiduciaries, brokerage houses, and pension management funds. For example, Citibank Colombia owns 32 percent of Colfondos, a pension fund management company.

Certain general foreign exchange and investment regulations, such as the prior approval rules governing acquisition of more than 10 percent of a company's shares, tend to discourage U.S. firms from operating in the securities market. However, the one U.S. firm that is established in Colombia reports no instances of discrimination.

Foreign financial institutions operating in Colombia feel that rules governing their establishment and continuing operations are transparent, and that they have sufficient opportunity to comment on proposed changes.

Total Stock and Bond Volume
(billions of pesos)

	Bogota Exchange	% of Mkt.	Occidente Exchange	% of Mkt.	Medellin Exchange	% of Mkt.	Total	% of Mkt
1992								
Stocks	198	5.1	63	4.4	223	25.1	485	7.8
Bonds	451	11.5	136	9.5	37	4.2	625	10.0
Other	3,265	83.4	1,237	86.1	627	70.7	5,130	82.2
Total	3,916	100.0	1,437	100.0	887	100.0	6,240	100.0
1993								
Stocks	274	4.1	112	4.7	319	19.9	705	6.7
Bonds	678	10.2	320	13.5	122	7.6	1,117	10.6
Other	5,655	85.6	1,941	81.8	1,159	72.4	8,755	82.8
Total	6,604	100.0	2,373	100.0	1,600	100.0	10,576	100.0

Other: Consists mainly of GOC paper and CDs.
Source: Bogota Stock Exchange.

Exchange Rates

Average 1993: $1 = 863.06 Pesos
End of year 1993: $1 = 917.33

VENEZUELA

BANKING

SUMMARY

The Venezuelan financial system is small and is characterized by the dominance of diversified financial groups. There is a trend toward consolidation and concentration, which is expected to continue. Total financial system assets have grown in recent years from $18.1 billion at the end of 1989 to $25.6 billion at the end of 1993. At present, the banking system is experiencing a severe structural crisis, and there has been a shift in total deposits towards banks perceived to be of higher quality. A number of institutions, representing over 50 percent of the deposit base, have been taken over by the government.

Prior to the recent crisis, the government of Venezuela had substantially reduced its ownership in the banking sector. Recent legislation provided a framework for establishment, over time, of a more efficient and regulated banking system. The new law allows for the establishment of universal banking, which will encourage consolidation of institutions within financial groups as well as bank mergers.

The new banking legislation has reinforced the autonomy of the Central Bank and has strengthened the powers of the Bank Superintendency. The Superintendency can now require greater disclosure and higher levels of capitalization. However, as the recent collapse of Banco Latino and problems of many other banks have shown, actual regulatory supervision is still weak and inefficient. In addition, depositors have tended to move their funds to healthier institutions in the aftermath of the collapse of Banco Latino and interventions of other banks.

Recently, there has been a dramatic improvement in the ability of foreign banks to enter and operate in Venezuela. Until January 1994, other than representative offices, foreign banks were essentially able to establish only through a joint venture, in which they could hold a maximum of 20 percent ownership interest. Reforms that became effective this year permit banks, from countries that provide reciprocal access to Venezuelan institutions, to establish branches or 100 percent foreign-owned subsidiaries and to acquire 100 percent of existing Venezuelan banks. Moreover, the country has lifted the onerous operating restrictions on established foreign banks, which prevented them from expanding or offering a competitive range of services. In addition to retail and corporate banking, foreign banks can issue credit cards, participate in ATM networks, deal in securities and engage in fund management. However, the difficulties that the banking sector is currently experiencing has dampened foreign interest.

Although the new legislation substantially liberalized treatment for foreign banks at the beginning of this year, the U.S. presence in the banking sector remains small. Currently, Citibank is the only U.S. bank with branches in Venezuela. Because of past discriminatory practices, entry into Venezuela by foreign banks has been concentrated on representative offices. As of December 31, 1993, 71 foreign banks maintained representative offices in Venezuela, of which 11 were U.S. banks. Some U.S. banks do have interests in separately established securities firms.

DESCRIPTION OF THE MARKET

In 1989, Venezuela embarked on an aggressive economic reform program. Market reforms were slow to come to the banking sector, but a number of measures have been implemented in recent years that promise to transform Venezuela's financial sector. These include the December 1992 Central Bank Law and a new General Bank Law that entered into force in January 1994. Recent legislation allows for the establishment of universal banking, which will encourage consolidation of institutions within financial groups as well as bank mergers. Prior to the new legislation, banks had largely narrowed the scope of their activities to focus on areas, such as real estate and public sector lending, where they perceived the opportunity to earn large profits with relatively low risk.

Unfortunately, the reforms came too late to avert a banking crisis in 1994. While the economic downturn of 1993 was the proximate trigger for the financial sector crisis, the underlying causes were bank mismanagement, fraud, and inadequate supervision by the regulatory authorities. Banco Latino, the second largest Venezuelan bank in terms of assets, closed its doors and was taken over by Venezuelan authorities. Banco Latino's failure affected the entire Venezuelan banking system. It led to a flight of deposits to banks perceived as more solid, causing liquidity problems for 11 other financial institutions, which were forced to borrow heavily from FOGADE (the deposits guarantee fund) and the Central Bank. As of August 1994, banks requiring assistance (including Banco Latino) represented over 50 percent of total system deposits. Although these banks remain open, the government has intervened in many and observers expect most will be liquidated.

Structure of the Banking System

As a result of earlier legislation, the Venezuelan financial system is highly segmented, with specialized and legally distinct financial subsectors. These include commercial banks, mortgage banks, investment banks, leasing companies, and the National System of Savings and Loan Associations. In practice, however, the financial system is highly concentrated, with most large and medium-sized banks being part of a diversified financial group, controlling entities in all major financial subsectors. A typical financial group is composed of a commercial bank, a leasing company, a mortgage bank, a credit card company, off-shore affiliates, and a securities firm.

There are 47 commercial banks in Venezuela, which maintain 1,895 branches and an extensive network of automated teller machines (ATMs). The commercial bank share of total financial sector assets has risen steadily to 74 percent in December 1993. In contrast, commercial bank assets as a percentage of gross domestic product (GDP) have declined from 36 percent in 1989 to 34 percent in 1993.

In recent years, political uncertainty has lowered real growth and hampered expansion of the financial sector. As a result, the banking industry remained small and attracted little capital investment. At the end of 1993, capital and reserves totaled Bs. 201 billion (about $1.89 billion). Total financial system assets were Bs. 2,714 billion (around $25.6 billion), or about the size of a U.S. regional bank. The stock of flight capital held abroad is thought to be at least several times greater than total deposits in the domestic market.

Commercial bank deposits at the end of 1993 totaled Bs. 1,455 billion (about $13.73 billion), an increase of 25.6 percent since year-end 1992. In real terms, however, bank deposits have contracted since 1992. As of December 31, 1993, the largest six banks (Banco Provincial, Banco de Venezuela, Banco Latino, Banco Maracaibo, Banco Mercantil, and Banco Union) held 54 percent of commercial bank deposits and earned 39 percent of total profits. However, the financial system crisis resulted in a major shift in bank deposits in the first half of 1994. For example, Banco Provincial, which is the nation's largest bank, saw its 14.5 percent share of total market deposits at year-end 1993 expand to 21.5 percent by the end of July 1994.

The government instituted exchange controls earlier in the year in response to the financial crisis. Consequently, foreign exchange can be bought and sold only through the Central Bank. The Foreign Exchange Board was established to regulate the exchange market.

The Central Bank also regulates interest rates. The Central Bank has set the interest rate spread at 25 basis points, based on the rate of return on the Venezuelan government 91-day zero coupon bond. Depositors receive a minimum rate of 10 percentage points below the 91-day rate; the maximum rate banks can charge customers is 15 percentage points above the 91-day yield.

Principal Components of The Venezuelan Financial System December 1993 (Bs. billions)

	Number	Assets	Percent of Total Assets
Commercial Banks (including public sector banks)	47	2,012.8	74.1
Mortgage Banks	16	170.2	6.3
Investment Banks	36	284.0	10.5
Savings & Loan Associations	20	136.2	5.0
Leasing Companies	35	111.1	4.1
Total	154	2,714.3	100.0

Commercial Bank Market Share Distribution December 1993

Market Share	No. of Banks	Percent of Deposits
More than 5 percent	6	54.1
Between 3 and 4.9 percent	4	16.3
Between 1 and 2.9 percent	15	23.9
Less than 1 percent	22	5.7
Total	47	100.0

State Presence

The government's role in the banking sector increased substantially in 1994 as a result of its intervention in nine banks and informal control of other assisted institutions pending liquidation or reprivatization. Assisted banks have put up a majority of their stock as collateral for FOGADE assistance. If that collateral is forfeited, the government of Venezuela will become, at least temporarily, the major stockholder. In any event, because of the sizable sums involved, the government is likely to play an important role in the operations of these banks for some time.

This represents a significant deviation, though presumably a temporary one, from the government's post-1989 policy of having only a small presence in the financial sector. Prior to the recent crisis, public sector institutions held only about 2 percent of total deposits. Three

institutions (Banco Republica, Banco de Occidente, and Banco Italo-Venezolano) that were previously fully state-owned have been privatized. A public institution that lent to the agricultural sector, Bandagro, has been liquidated. The Banco de Los Trabajadores de Venezuela was taken over by the regulatory authorities on February 7, 1994, and will be liquidated. The government still owns Banco Industrial de Venezuela (BIV), which provides long-term development finance for projects that are high political priorities. The government also owns four regional institutions that play an inconsequential role in the market. The BIV and the regional banks, combined, hold the 2 percent of total deposits cited above.

Regulatory Authorities

The new banking law makes the Superintendency of Banks an independent agency and expands its regulatory role to include not only banks but also other financial institutions. Funding will come from a mix of sources but will include revenues from technical services and the government's budgetary resources. The Superintendency's regulatory powers are strengthened, and it can issue its own regulations. Reporting requirements have been tightened to improve information about offshore operations and activities within the financial group. Financial statements must be prepared on a consolidated basis.

Capital requirements also were strengthened under the new law. Banks must comply with Basle guidelines and achieve a minimum capital-to-risk assets ratio of 8 percent. Initially, banks were given until the end of 1994 to meet this requirement; the deadline was later extended to the end of 1995.

The Deposit Insurance Agency, FOGADE, also became an independent agency and gained responsibility for bank interventions and liquidations under the new law. It provides deposit insurance up to a maximum of 4 million bolivars. (The maximum had been 1 million bolivars but was raised following the Banco Latino collapse.) To fund the insurance program, banks pay a fee, currently set at 1 percent of total deposits, at the end of each semester. FOGADE also can provide financial assistance to financial institutions to re-establish liquidity and solvency and can liquidate financial institutions. FOGADE is funded through a variety of sources, including Government revenues, profits from its operations, bond issuances and payments by financial institutions. In addition, the Central Bank can make loans directly to FOGADE. This has been the primary source of FOGADE funds during the recent crisis.

With prior approval of the Central Bank and the Superior Council of the Superintendency of Banks (comprised of the Minister of Finance, Bank Superintendent, Central Bank president, and FOGADE president), the Superintendency can intervene in (or take over the operations of) a troubled bank or financial institution. In such a situation, the Superintendent of Banks can designate an intervenor. FOGADE oversees the process of liquidation if that decision is taken by the government. An Emergency Financial Board, with broad powers over the financial

system, has been established. The new board has substantial regulatory and intervention powers to address the financial crisis.

U.S. PRESENCE IN THE MARKET

Because of past restrictions, U.S. and foreign financial institutions today have only a minimal banking presence in Venezuela. Citibank Venezuela, founded in 1917, is the only U.S. bank operating branches in Venezuela. Citibank's participation in the Venezuelan system is practically synonymous with the foreign presence in the sector, which remains very small, accounting for less than 1 percent of both deposits and assets.

Foreign, non-U.S. banks maintain a limited presence in Venezuela. Credit Lyonnais owns less than 20 percent of Banco Provincial. Banco do Brasil has a commercial banking presence in Caracas. Extebandes, a small, multinational bank, has capital subscribed by investors from Spain and Andean Pact members and, for legal purposes, is treated as a national bank. In 1992, Venezuela, through presidential decree, loosened its regulations on foreign participation in the commercial banking sector and allowed institutions domiciled in other Latin American countries to enter the Venezuelan market on the basis of reciprocity. Through this mechanism, Colombian institutions (Banco Tequendama and Banco Ganadero) have established banking offices in Venezuela to take advantage of Colombia-Venezuela integration.

In recent years, despite constraints on establishment of majority foreign-owned full fledged commercial banks, the foreign presence has increased as institutions have opened representative offices. These include Bank of America, Bankers Trust, Chemical Bank, Bank of New York, and Chase Manhattan Bank, several of which also have securities subsidiaries, as does Citicorp. As of December 1993, 71 foreign banks maintained representative offices in Venezuela; 11 were U.S. institutions. These banks provide a variety of financial services, including arranging medium- and long-term dollar financing, clearing wire transfers, servicing corporate clients, and arranging debt-equity swaps.

Foreign Bank Presence in the Venezuelan Banking System December 31, 1993 (Bs. billions)

Banks	Assets	Percent of Total	Deposits	Percent of Total
Citibank	9.41	0.47	6.59	0.45
Tequendama	0.41	0.02	0.12	0.01
Banco do Brasil	0.17	0.01	0.02	0.00
Ganadero	0.72	0.04	0.00	0.00
Total	10.71	0.54	6.73	0.46

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Venezuelan policy dating from the early 1960s limited entry and operation of foreign banks. For most of that time, new banking licenses were not issued, and established foreign banks could not expand their existing branch networks. In addition, highly restrictive and discriminatory operating and legal constraints were adopted in 1975. Banking legislation of 1975 and 1988 stipulated that capital of any new bank must be at least 80 percent Venezuelan-owned. Foreign banks established prior to the 1975 law were required to reduce their equity ownership to below 20 percent or retain their foreign ownership and operate under highly discriminatory conditions, as did Citibank.

Foreign banks "grandfathered" under the 1975 law were not allowed to add branches; could not increase local capital; were subject to a higher leverage ratio (of liabilities versus paid-in capital and reserves) than domestic banks; were prohibited from offering savings accounts or issuing negotiable certificates of deposit; could not purchase foreign exchange from the central bank; and were not permitted to do business with state-owned companies.

In a major policy reversal, the new General Bank Law dramatically improved access to the market and the operating conditions for foreign institutions. As of January 1, 1994, the new legislation removed the barriers to entry by foreign banks from countries that provide reciprocal access to Venezuelan banks. Foreign banks may now enter the Venezuelan market in one of three ways: acquisition of shares in existing commercial banks or other financial institutions; creation of a new bank or other financial institution wholly owned by foreign banks or investors; or establishment of a branch of a foreign bank or financial institution.

Once established, foreign banks are to receive treatment comparable to that provided to domestic banks. The activity limitations on grandfathered banks were removed by the new legislation.

In addition to retail and corporate banking, foreign banks can issue credit cards, participate in ATM networks, and engage in fund management. Foreign exchange trading is limited due to exchange controls currently in effect. Under the 1994 banking law, banks can engage in securities activities; however, in practice foreign banks participate through separately established securities firms. Capital requirements are less onerous if an institution establishes a separate securities firm.

Applications for entry are submitted to the Bank Superintendency, which has not yet issued implementing regulations. However, a Dutch bank, ING, has had an application approved under the new banking law.

VENEZUELA

SECURITIES

SUMMARY

For a variety of reasons, the Venezuelan private capital market is small. Most transactions are handled on the Caracas Stock Exchange, where trading is thin and highly concentrated. Market capitalization as a percent of GDP has declined in recent years. At the end of 1993, it stood at $7.9 billion, or 11 percent of GDP. The equity market is volatile and subject to frequent sharp movements.

The 20-year-old Capital Markets Law needs to be updated to ensure greater transparency. The market's chief regulatory authority, the National Securities Commission (CNV), lacks authority to prosecute market wrongdoers.

Residents may access offshore securities markets to raise capital, but access to offshore markets for investment purposes is difficult under the current foreign exchange controls. Nonresidents may freely invest in Venezuelan securities, subject to certain restrictions in certain sectors of the economy.

Subject to authorization, foreign financial firms may enter the Venezuelan securities market either through the purchase of an existing bank or financial institution, de novo establishment, or by branching. A few U.S. investment firms have established offices in Caracas to pursue investment advisory services. One U.S. financial institution has a seat on the Caracas Stock Exchange. Most of the U.S. presence in the Venezuelan securities market is in the form of representative offices.

DESCRIPTION OF THE MARKET

Caracas Stock Exchange

The Caracas Stock Exchange is a privately owned corporation. It has been in operation since 1947. A second regional exchange was opened in Maracaibo in 1986, but trading volume on the Maracaibo Exchange is less than 5 percent of the trading volume handled by the Caracas Exchange.

Although a few private bonds, warrants, and Global Depository Receipts (GDRs) are traded, equity transactions account for 98 percent of the volume and value of trading on the Caracas Exchange. Almost all private and public debt instruments are either placed in the primary (Caracas) market or traded privately.

Membership on the stock exchange is open to both individuals and to legal entities. Some local commercial banks have purchased seats in their own names. The 55 seats on the Caracas Stock

Exchange have sold for as high as $1 million in recent years, but more recently a seat sold for $123,000. The minimum capitalization of a broker or a brokerage firm is Bs. 10 million (about $58,800).

For a variety of reasons, the Venezuelan private sector has not used equity finance as a significant source for raising new capital. Among the principal reasons are a traditional reluctance of family enterprises to cede even minority control to outsiders; an unwillingness of companies to meet public disclosure requirements; access to subsidized government credits or to commercial credits provided by financial entities linked to an industrial group; access to external credit; double taxation of dividends; and the hazards of a small, concentrated, and volatile secondary market. Additionally, in the 1980s, prior to the implementation of economic reforms, the Central Bank often set interest rate ceilings below the prevailing inflation rate, which induced excessive commercial credit demand.

In 1993, the private sector issued $898 million in stocks and bonds, $653 million in commercial paper, and $44 million in trust certificates. The private sector also obtained external financing through commercial banks and eurobond placements. The financial sector issued 47 percent of all private sector instruments offered. Shares of several Venezuelan private firms trade in U.S. equity markets as American Depository Receipts (ADRs). In 1993, three Venezuelan companies issued $211 million in ADRs, and one company offered a $48 million ADR.

Trading on the Caracas Exchange is thin and highly concentrated. Average daily transactions in 1993 were 691. Of the 93 firms listed on the exchange at the end of 1993, only about 60 are normally traded. Of these, 13 comprise 90 percent of the volume traded and 10 represent 85 percent of the market's capitalization. About 10 of the 55 brokerage houses received about 50 percent of brokerage commissions. Caracas's utility, La Electricidad de Caracas, dominates trading with about 60 percent of volume. Nonfinancial firms are a minority; only about 30 are traded, including about 18 manufacturing firms.

For 1993, market capitalization was Bs. 837 billion ($7.9 billion) at year-end, or 11 percent of GDP. Market capitalization has declined as a percentage of GDP for three successive years, although foreign investment in the Caracas Exchange has risen. Total foreign investment recorded on the Caracas Exchange was $190 million at year-end 1993, up from $49 million in April 1993.

Another underlying characteristic of the Caracas stock market is its volatility. The exchange's broad market index has declined in recent years. After climbing steadily to a peak of 33,796.4 in February 1992, the index fell to a low of 18,002.3 in January 1993. The index closed 1993 at 22,031, a 10 percent increase in nominal terms during the year. However, in real terms, the index fell 17.5 percent for the year. There was a 36 percent drop in the financial component of the index, while industrials rose 10 percent in real terms.

Regulatory Authority

The Capital Markets Law of 1975 regulates the public offering of shares and medium- and long-term securities, except public debt bonds and credits.

The National Securities Commission (CNV), under the Ministry of Finance, is the chief regulatory authority of the local stock exchanges. The CNV is limited in its ability to regulate the market because it has no legal capacity of its own to impose criminal sanctions for violations of legal or regulatory statutes. In addition, maximum administrative fines contained in the 1975 Capital Markets Law have not been updated and, at under $400 per infraction, appear to be more of a nuisance than a deterrent.

Recent Developments

The Caracas Stock Exchange is often criticized for lack of transparency and inefficient operations. A poor settlements process with frequent reconcilement problems also has limited the desire of local and foreign investors to trade equities in this market. However, progress is underway to address these problems and to modernize the exchange. The CNV and the Caracas Exchange have made substantial progress to improve the settlement process by means of a new automated system. An electronic market clearinghouse and central depository have been proposed by the exchange to the government.

The CNV recently issued regulations governing trade in futures, options, investment funds, and derivatives. The Caracas Exchange is seeking authority to again trade government securities and be the principal secondary market for foreign exchange trading. The CNV's efforts to demand fuller disclosure of company financial data and reform regulation of such practices as insider trading, front running, short selling, and personally owned broker portfolios have made some headway, but the pace is slow. Competition is coming: plans of a rival group, supported by the IFC and the Andean Development Corporation, are well advanced to establish an electronic exchange that would initially trade only debt securities.

Proposed Capital Markets Legislation

There is growing support for a substantial revision of the outdated Capital Markets Law. A bill that is being revised by the government would, among other things, strengthen the regulatory environment that governs Venezuela's equity markets. It would provide new regulations for intermediaries, establish new conditions for public offerings, and make regulations more flexible for small firms that wish to issue stock. It was originally planned as an integral part of the comprehensive financial sector reform announced by President Carlos Andres Perez' economic team in mid-1991. However, disputes among various sectors have delayed completion of an acceptable draft.

Capital Movements

There are no general limitations on foreign direct or portfolio investment. However, there are limits on the share of foreign ownership in certain sectors such as radio and television and petroleum. The promulgation of Presidential Decree 727 (1990), which liberalized foreign investment in general, removed most legal barriers to foreign participation in the local securities market. Under the General Banking Act of January 1994, foreign investment in the banking sector is permitted. U.S. financial institutions in the Venezuelan market can now purchase any amount of stock in any company listed on the Exchange without a statutory maximum. Prior approval of the investment by the Foreign Investment Superintendency (SIEX) is no longer required, although investments must be registered with SIEX.

Foreign investors may repatriate dividends and capital, but they must register with the Office of Technical Administration of Foreign Exchange to receive foreign currency under the current foreign exchange control regime. Dividends are not taxable, but a capital gains tax of 30 percent is levied on gains made from trading stock. Recently implemented tax legislation eliminated the capital gains tax on shares and substituted a 1 percent tax on the trading of securities.

Residents may freely access offshore markets as issuers of securities or notes, but they are required to obtain prior authorization from the National Securities Commission to do so. Residents also must register with the Technical Exchange Management Office (OTAC), which oversees exchange controls.

As of July 9, 1994, with the introduction of foreign exchange controls, residents have limited access to foreign exchange and thus limited access to new offshore financial instruments.

U.S. PRESENCE IN THE MARKET

The U.S. presence in Venezuela's small capital market is modest. Citicorp purchased a seat on the Caracas Stock Exchange in 1988 for its local brokerage house, Citimerca. In addition to Citicorp, as of December 1993, 11 other U.S. commercial or investment banks had representative offices in Venezuela. Other U.S. commercial and investment banks participate indirectly in the local capital market, either from offshore or by using local Venezuelan firms as intermediaries. Activities include consulting, investment advising, underwriting, and placing dollar-denominated public sector debt instruments with local and foreign clients.

There are no significant impediments to entry and operation of U.S. financial institutions. However, because of Venezuela's economic recession, policy uncertainties, and insufficient transparency in market operations, interest by U.S. financial institutions in expanding in Venezuela's local capital market remains small.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Restrictions on entry of foreign financial institutions have eased in recent years. The General Banking Act of 1994 permits foreign institutions to own bank branches and subsidiaries, as well as wholly-owned investment banks and universal banks. Presidential Decree 2095 (of 1992) enables foreign institutions to establish local investment companies, giving them greater access to Venezuela's securities market.

Banks may engage in a full range of securities activities under the 1994 law, but they typically participate only indirectly through securities firms that they own.

Foreign banks and securities firms also are allowed to engage in fund management activities, subject to authorization from the National Securities Commission.

There are no impediments to the introduction of new financial products. However, some transactions may require prior approval from the Superintendency of Banks.

Foreign corporations located in Venezuela may issue stocks, bonds, or commercial paper on the domestic market, provided they comply with the regulations established by the National Securities Commission and the provisions of capital markets legislation.

Venezuela residents may access offshore securities markets for fundraising purposes, but residents have very limited access to offshore securities markets for investment purposes. Nonresidents may invest in Venezuelan securities, subject to certain restrictions in certain sectors of the economy.

AUSTRALIA

BANKING

SUMMARY

The Australian financial system grew rapidly in the 1980s, due in large part to deregulation. With that growth came a broadening of services and a deepening of financial markets. In the last few years, there has been some restructuring of institutions and readjustment of financial firms' corporate strategies in light of the increasingly competitive environment in the country.

The Australian financial market at present is served by four major nationwide full service banks, a score of regional banks, and many nonbank financial institutions. As of January 1994, there were 33 banking groups in Australia, and 39 banks were authorized under the banking act. The banking sector dominates financial intermediation in Australia, with just over 76 percent of assets in Australian financial intermediaries (as of January 1994). The banking sector is regulated by the Reserve Bank of Australia (RBA).

Australian Commonwealth Government (federal) policy towards foreign-owned banks has changed substantially in recent years. In 1984, the treasurer announced that the government would permit limited foreign bank entry into the Australian financial system through locally incorporated subsidiaries. This led to the establishment of 15 new locally incorporated banks that were wholly or substantially owned by foreign banks. Some of these licenses were granted to foreign banks that already had a presence in Australia, in the form of either a finance company or money market corporation.

In February 1992, Prime Minister Keating announced a further liberalization. Subject to compliance with prudential guidelines, there would be no limit on the number of foreign bank licenses, and foreign banks would be permitted to operate through a branch, as well as through a locally incorporated subsidiary, or through both. The government's stated objective in the liberalization was to enhance Australia's access to foreign capital and increase competition in the financial system. As implemented by the Reserve Bank, this initiative permits foreign banks to operate as branches but requires retail deposit taking operations to be conducted by a locally incorporated subsidiary. The imposition of an Interest Withholding Tax on intrabank financing acted to discourage some foreign banks from establishing in branch form. In December 1993, the government took steps to reduce some of the impact of the tax on foreign bank branches.

The government will allow foreign banks to acquire domestic banks on a case by case basis, but the four largest Australian banks are excluded from consideration.

As of the end of December 1993, 14 foreign banking groups were operating in Australia through locally incorporated subsidiaries of foreign banks and four were established as foreign bank branches. The majority of foreign banks commenced operations in late 1985 and early 1986.

Between June 1984 and December 1993 foreign-owned banks increased their share of total Australian bank assets from 1.6 percent to 12.5 percent. Some of this increased share reflected the transfer of assets from foreign bank-owned money market corporations and finance companies into newly authorized banks.

DESCRIPTION OF THE MARKET

Over the past 10 to 15 years the Australian economy has undergone a fundamental transformation as policies have shifted from inward-looking measures, designed to protect existing industries, toward an outward focus, as the country sought to be more internationally competitive and a regional economic power. An important element of this change was the transformation and restructuring of the financial sector begun in the mid-1980s with the floating of the exchange rate and the opening up of the banking system to new foreign entrants.

Deregulation of the financial system has produced a new and more challenging environment for banks. Banks have faced the rigors of more intense competition, and traditional relationships with customers have been transformed, requiring banks to be more responsive and innovative. The increase in bank competition, combined with the boom-bust of the business cycle in the 1989-91 period, took its toll on bank profitability.

Structure of the Market

The Australian banking sector encompasses a variety of types of financial institutions, but is dominated by commercial banks. The other most important participants are finance companies and money market corporations. In part because of deregulation and the liberalization of bank entry (as nonbank financial intermediaries converted to banks), the commercial bank share of the market has increased steadily in recent years, while that of its major competitors has shrunk.

The most important banks in Australia are the four major institutions that have a nationwide presence. Three are privately owned — National Australian Bank, Westpac, Australia and New Zealand Bank. These banks accounted for almost one half of total bank assets as of the end of 1993. The fourth major bank, Commonwealth Bank of Australia, is majority federal government-owned and together with the other three state banks held just under 30 percent of the system's assets. The balance of assets were divided between eight smaller privately owned Australian banks and foreign banks.

Trends in Financial Intermediation Market Share
(percent of total assets as of year end)

	1989	1990	1991	1992	1993
Banks	66.5	69.3	70.9	73.4	76.5
Domestic Banks	59.1	61.9	61.3	65.8	68.1
Foreign Banks	7.5	7.5	7.8	7.6	8.4
of which U.S.-owned	2.6	3.2	3.2	3.1	3.6
Nonbank Financial Intermediaries	33.5	30.7	29.1	26.6	23.5
Money Market Corporations	11.5	9.5	9.0	8.8	8.2
of which U.S.-owned	1.4	0.8	0.8	0.7	0.7
Finance Companies	10.5	9.9	8.5	7.8	7.4
of which U.S.-owned	0.4	0.4	0.2	0.2	0.1
Building Societies	4.6	4.2	4.1	2.2	2.5
Credit Unions	1.7	1.7	1.9	2.0	2.3
Authorized Money Market Dealers	0.8	0.7	0.7	0.8	1.0
Other	4.4	4.6	4.8	5.0	2.2
Total Financial Intermed.	100.0	100.0	100.0	100.0	100.0
of which U.S.-bank owned	3.0	3.7	3.4	3.3	3.7

Note: Data used for banks from 1990 is based on assets recorded on banks' Australian Books; prior to this date, it is based on assets within Australia.

Source: The Reserve Bank of Australia

Bank ownership by individuals or corporations is generally limited to 10 percent; individual ownership can be increased to 15 percent with the approval of the treasurer. The governor-general may fix a higher limit up to 100 percent. This higher limit mainly been used to allow overseas parents of foreign subsidiary banks to own 100 percent of their Australian entities.

As illustrated in the accompanying table, private and government-owned banks compete actively against each other and have a very similar portfolio of assets. Both are heavily engaged in consumer lending, which accounts for over 30 percent of their total assets. In contrast, foreign banks tend to be much more active in the interbank market and their lending is concentrated in wholesale loans to the commercial sector.

Market Share of Banks Operating in Australia
Year-End 1993

Banking Group	Number of Banking Groups	Total Assets (AUD million)	Percent of Total Assets
Domestic-Owned Banks	15	357,271	89.1
- Major Privately Owned Banks	3	194,110	48.4
- Other Private Banks	8	45,624	11.4
- Government-Owned Banks	4	117,536	29.3
- Foreign-Owned Banks	18	43,826	10.9
- Subsidiaries	14	37,424	9.3
- of which U.S.-Owned	4	18,741	4.7
- Branches	4	6,402	1.6
- of which U.S.-Owned	0	0	0.0
Total	33	401,096	100.0

Source: The Reserve Bank of Australia

Finance companies began as providers of motor vehicle finance in the 1920s. By the 1950s they were established as a major group of financial intermediaries in the provisions of hire-purchase and installment credit. Their development was aided from time to time by restrictions on banks. When restrictions were relaxed and business flowed back to banks, finance companies shifted focus to other areas, where they felt they were most competitive, especially various forms of commercial finance, including leasing, inventory financing, factoring, and real estate development. Finance companies primarily deal with households and small and medium-sized businesses. Funds are obtained by the issuance of debentures to both retail and wholesale investors and by borrowing on domestic and overseas wholesale markets.

The market share (and number) of finance companies has been in steady decline since early 1988. As of April 1994, no finance company is directly owned by a foreign bank. However, two are controlled through Australian banking subsidiaries of U.S. banks and three through foreign finance companies owned by foreign banks.

Money market corporations (MMCs) were first established in the 1950s in response to controls restricting banks' operations in short-term borrowing and lending. MMCs were the vehicles used by foreign banks in the late 1970s and in the 1980s to obtain a presence in Australian financial markets in the face of then-existing restrictions on the entry of foreign banks. MMCs engage primarily in providing services to the wholesale sector, including raising funds, providing

financing, corporate advisory services, asset management and conducting general money market activities (including securities and foreign exchange dealing). Many of these services are similar to those offered by commercial banks. MMCs generally do not accept retail deposits and are not part of the interbank settlement system. They are neither authorized nor subject to prudential oversight by the Reserve Bank of Australia. Where they engage in securities and foreign exchange dealing, however, MMCs are required to be authorized by the Australian Securities Commission and the Reserve Bank respectively.

MMCs are also known as "merchant banks." Althought they are not authorized banks, they have been granted approval to use the terms "merchant bank/banking" as descriptive terms in letterheads, advertising material etc., but they are not permitted to incorporate the word "bank" in their title.

Composition of Assets as Reported on Banks' Australian Books (percent as of year-end 1993)

	Privately Owned	Government Owned	Foreign Banks
Australian Notes and Coins	0.6	0.7	0.0
Deposits with RBA	0.8	0.7	0.7
Public Sector Securities	6.5	8.3	13.2
Balances with Fin. Intermed.	6.6	8.7	25.5
Lending	59.7	63.5	39.9
Housing	(30.1)	(30.4)	(7.0)
Commercial	(15.8)	(16.7)	(25.6)
Government	(1.2)	(2.8)	(0.7)
Personal	(7.6)	(6.8)	(1.8)
Other	(5.0)	(6.8)	(4.8)
Bills/Acceptance	15.1	9.2	2.3
All Other	10.7	8.9	18.4
Total Assets	100.0	100.0	100.0

Source: Reserve Bank of Australia

Tight monetary policy, high interest rates, and the collapse of asset prices, especially in the commercial property market, resulted in major difficulties for financial institutions in the late 1980s and the early 1990s. The 1991 recession prolonged the difficulties for banks and other

key sectors. Financial institution profitability has been particularly poor over the last few years in MMCs, with the largest losses concentrated among a small number of institutions (mostly domestically owned). Those MMCS have subsequently withdrawn from the industry. Wholesale and retail banking firms, both domestic and foreign, are increasing their market share as a consequence.

There was a rapid growth in employment in the financial sector in the mid-1980s following deregulation and expansion in the industry. The past five years have, however, witnessed a decrease in the total number of wage and salary earners employed by financial intermediaries in Australia. Further lay-offs and employee reductions are not expected. The sector is expected to stabilize in the near term, following its rapid expansion spurred by government deregulation in the mid-1980s and then some subsequent retrenchment. The banking industry accounted for 2.6 percent of employment, or approximately 153,600 wage and salary earners, as of March 1993. Nonbank financial intermediaries engaged an additional 22,800, or about 0.4 percent of the total employed. A further 44,600, or about 0.8 percent of the work force, provided investment services.

Number of Wage and Salary Earners (in thousands)

	Banking		Nonbank Finance		Investment Services	
1989	160.9	(2.6)	37.4	(0.6)	71.0	(1.1)
1990	170.2	(2.8)	36.8	(0.6)	52.2	(0.9)
1991	157.1	(2.7)	30.0	(0.5)	42.7	(0.7)
1992	152.4	(2.6)	27.4	(0.5)	46.5	(0.8)
1993 *	153.6	(2.6)	22.8	(0.4)	44.6	(0.8)

* All figures are as of March 1993.

Notes: The figures in this table were compiled by the Australian Bureau of Statistics (ABS).
Percentages in parentheses represent the percentage of employed working in those industries.

Banking Regulation

Australian banks are regulated by the Reserve Bank of Australia. There is no deposit insurance in Australia. The Banking Act (1959), however, provides that it is a duty of the Reserve Bank of Australia to protect the interests of all depositors in Australia of banks authorized under the Banking Act (including locally incorporated subsidiaries of foreign banks but excluding foreign banks operating as branches). The Reserve Bank may investigate a bank, and if it considers it appropriate, assume control of the bank and carry on its business. In such a case, the Reserve Bank is obliged to remain in control until the deposits of the bank have been repaid or the Reserve Bank determines that suitable arrangements have been made for their repayment.

Assets of a bank in Australia are required to be available to meet its deposit liabilities in Australia in priority to all other liabilities of the bank. The Reserve Bank does not, however, guarantee repayment of depositors' funds. Typically, should the Reserve Bank feel that a bank is encountering severe problems, the Reserve Bank would likely look to orchestrate a takeover of the troubled bank by a more secure bank.

U.S. PRESENCE IN THE MARKET

As of December 1993, 14 wholesale and retail banks operated in Australia as locally incorporated subsidiaries of foreign banks, and four operated as foreign bank branches. The number of applicants for banking authorities increased significantly in 1994, and three U.S. banks had by late September been granted banking authorities to operate as branches in Australia, in addition to the four U.S. banks operating as subsidiaries in 1993.

In the early 1990s, some foreign and domestic banks experienced large losses in Australia. The losses were mainly attributed to bad loans, and forced most institutions to alter the focus of their operations and to concentrate on corporate clients, and in particular to take advantage of their multinational presence and access to offshore funding and widespread business relationships. This recent change in focus, coupled with a revival of investment activity, has resulted in healthy profits for many foreign institutions in 1993. For example, Citibank, the U.S. bank with the largest presence in Australia, had an increase in profits of 62 percent in 1993.

The liberalization of the past decade has created greater opportunities for foreign banks, and a number of U.S. firms have taken advantage of these new opportunities. With the Australian economy expanding strongly this year and next, these opportunities are expected to grow further. Reflecting improvements in the economy, American financial institutions are enjoying increased profits and returns.

Profit Results for American Banks in Australia for Year Ending December 1993

	Net Profit ($M)	% Increase in Net Profits	Total Assets ($BN)	Return on Equity
Bank of America	58	429	1.3	41
Chase Manhattan	71	446	1.2	45
Bankers Trust	274	34	5.7	32
Citibank	105	62	8.8	16

Source: Derived from published Annual Reports.

Comparative Performances of Foreign and Domestic Banks in Australia (percent)

	1991		1992		1993	
	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
Change in Total Assets	-0.28	5.54	3.71	1.09	3.90	5.15
Change in Net After-Tax Profit	-0.98	-54.90	n.a.	n.a.	n.a.	122.73
Net Interest Income to Average Assets	2.96	1.67	2.88	1.95	2.97	1.83
Non-Interest Income to Average Assets	2.00	2.99	1.78	3.26	1.71	4.14
Non-Interest Exp. to Average Assets	3.15	3.28	3.33	3.27	3.12	3.49
Net Profit After Tax to Average Assets	0.54	-0.95	-0.17	0.95	0.46	2.06
Net Profit After Tax to Average Net Profit	6.63	-11.65	-1.93	11.12	5.35	21.09
Total Capital Ratio	10.72	10.45	10.47	12.35	11.62	15.16

Notes: Figures are from banks' financial reports.
Care needs to be taken when comparing the performance of domestic and foreign banks for the above years. The large losses reported by some of the major banks for the 1991/92 financial year obscure the sound performances of other domestic banks.

Source: Derived from published Annual Reports.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

American bankers in Australia generally believe that the operating environment in Australia is fair. While they disagree with aspects of regulatory and prudential requirements, they do not believe these requirements are imposed in a manner that discriminates against foreign firms.

Foreign financial institutions seeking a banking presence in Australia are required to meet a specific set of criteria. Foreign banks wishing to operate through branches must be of substance and high standing, satisfy the Reserve Bank that they are subject to adequate standards of prudential supervision in their home country (including compliance with Basle minimum capital adequacy standards), have adequate management, systems, and controls, and submit an acceptable business plan. Foreign banks wishing to establish locally incorporated banking subsidiaries must comply with all the prudential requirements applied to locally owned banks, including minimum amounts of capital.

Foreign institutions wishing to establish a nonbank financial intermediary are required to incorporate in Australia, although no authorization procedure is required. However, in order to undertake securities or foreign exchange dealing, such institutions require authorization from the Australian Securities Commission or the Reserve Bank of Australia, respectively. Such authorization may require compliance with set criteria including demonstrated expertise, adequate management, and minimum capital requirements. Similar requirements are applied to locally owned financial institutions undertaking the same activities.

There was consensus among the American firms interviewed in Sydney that the criteria that must be met are similar to the prudential criteria required by U.S. regulators. Moreover, industry sources believe that the Australian financial system is beginning to mirror the American financial system in the way in which it operates.

However, the Australian government has a policy of limiting foreign ownership of the Big Four domestic banks to 10 percent, with a maximum of 15 percent possible, subject to approval by the treasurer.

Deposit-Taking Restrictions on Foreign Bank Branches

One regulation that does affect the operations of foreign, including U.S. banks, is the requirement that foreign-owned branch banks confine their deposit-taking activities to "wholesale" markets. The guidelines for permissible wholesale activities are as follows:

A branch of a foreign bank is:

(I) permitted to accept deposits and other funds (in any amount) from:
- incorporated entities;

- nonresidents; and
- employees of the bank.

(II) not permitted to accept initial deposits (and other funds) from other sources (individuals and noncorporate institutions) that are less than A$250,000.

Source: The Reserve Bank of Australia

Technically, deposits in foreign branches are not subject to the provision of the Banking Act, which requires the Reserve Bank to protect the interests of their depositors. Foreign branches are required to notify all depositors accordingly. Locally incorporated banking subsidiaries of foreign banks are permitted to accept "retail" deposits, because their depositors are protected. Grandfathering provisions were made available to the three foreign bank branches existing when the regulation was implemented. U.S. and other foreign-owned banks believe this restriction, which is based on prudential objectives, is overly protective of retail depositors and limits foreign bank profitability.

In 1991, the U.S. imposed similar restrictions on retail deposit-taking by foreign bank branches, although retail deposits were defined less strictly, at $100,000 for initial noncorporate, nonemployee deposits. Moreover, insured foreign bank branches in the United States at the time the law was changed, including those of Australian Bank Westpac, were grandfathered and allowed to continue to take retail deposits.

Foreign-owned authorized banking subsidiaries are supervised by the Reserve Bank of Australia on the same basis as locally owned banks. Foreign bank branches are also subject to prudential supervision by the Reserve Bank. However, they are not required to hold any "endowed" capital in Australia, nor are they subject to the Reserve Bank's large credit exposure limits.

Many foreign banks operating in Australia either through existing authorized locally incorporated banks or nonbank financial intermediaries were reluctant to apply for branch status under the liberalized rules for branch operations. This reflected primarily problems over the taxation arrangements to be applied to branches. Banks were also discouraged from establishing a branch as a result of the restrictions placed on branches accepting "retail deposits."

Interest Withholding Tax on Foreign Bank Branch Overseas Borrowings

The application of the Interest Withholding Tax (IWT) to intrabank funding limited the attractiveness of establishing a branch, because it made overseas borrowing relatively more expensive for branches than for locally incorporated institutions (including foreign-owned subsidiaries). Locally incorporated institutions are permitted to issue widely distributed securities overseas free of IWT, under section 128F of the Australian tax code. However, branches are not granted similar treatment, since such issues are deemed to be represent

intrabank funding, which is subject to IWT. Foreign bank branches could not effectively utilize separate nonbank subsidiaries to access IWT exempt funds to lend in Australia, since Reserve Bank policy held that nonbank subsidiaries of banks were to be limited in size and that the "bulk of intermediation" of funds had to go through the bank itself.

In recognition that locally incorporated institutions held a funding cost advantage relative to foreign bank branches, a concessional IWT rate was applied to foreign branches to partly ameliorate their situation. Then, in December 1993, the Reserve Bank announced that it would modify its bulk of intermediation requirements to allow foreign banks with branch operations to establish nonbank subsidiaries in Australia to borrow IWT exempt funds for on-lending in Australia, provided that these subsidiaries solely lend section 128F funds directly to Australian entities (as opposed to through the branch).

The American banking community is generally pleased with government efforts to accept applications for branch status and improve access to section 128F funding, but opinions vary on what effect the new branch status will have. Those institutions that operate in wholesale banking believe business will now be on a more level playing field and more profitable, while those in retail banking believe profits will not be enhanced.

AUSTRALIA

SECURITIES

SUMMARY

The rapid growth and deregulation in the Australian financial markets in the 1980s gave a boost to development of the securities markets. In 1987, the six regional stock exchanges were merged into the Australian Stock Exchange (ASX). At the end of 1993, there were 1107 listed corporations on the exchange with a market capitalization of AU$293 billion. Fixed income securities listed on the ASX had a total market value AU$107 billion.

The Sydney Futures Exchange (SFE) has been in operation since 1960, and now trades both commodity and finanacial futures. In 1989, the SFE introduced an after-hours screen trading system to facilitate overseas trading in Australian futures contracts.

Money market corporations (merchant banks), banks, authorized money market dealers and securities brokers participate in Australia's securities markets.

U.S. banks own 14 of the 88 registered money market corporations. Two U.S.-owned firms are authorized money market dealers.

American firms contacted reported no discriminatory impediments to establishment or operations. However, foreign investment in 15 percent or more of a company's equity is subject to a screening test. In practice, this has not presented any difficulties to date.

DESCRIPTION OF THE MARKET

Market Structure

The Australian Stock Exchange (ASX) was incorporated in 1987 on the basis of a consolidation of six regional exchanges. The stock market is made up of the new issues and the secondary market. The ASX also operates the Australian Options Market for equities. Membership consists of both individuals and corporate members. Only those financial institutions that are members of the ASX can engage in equity brokerage activities.
Australian-owned firms dominate the stock brokerage business in Australia.

At the end of 1993, there were 1107 listed corporations on the exchange with a market capitalization of AU$293 billion. Fixed-income securities listed on the ASX had an total market value AU$107 billion. Forty foreign companies are listed on the ASX. Foreigners owned about 32 percent of the equity of Australian companies as of March 1994.

The Sydney Futures Exchange (SFE) has been in operation since 1960, and now trades both commodity and financial futures. In 1989, the SFE introduced an after hours screen trading systemS to facilitate overseas trading in Australian futures contracts.

Money market corporations (MMCs) are the most important players in the Australian securities markets, functioning as merchant/investment banks. MMCs primarily engage in providing financial services to the corporate sector. They raise funds and provide financing for corporations, including through underwriting debt and equity issues. They engage in securities and foreign exchange dealing, provide corporate advisory services and offer fund management services.

In conjunction with moves to liberalize foreign bank entry, the government lifted restrictions on foreign ownership of certain nonbank financial intermediaries in 1984. When the MMC industry was opened up, it caught the attention of foreign banks, which initially were not permitted to operate in Australia as banks. This resulted in the creation of 37 new nonbank financial entities, of which most were MMCs. Of these 37 new nonbank financial entities, more than one-half were owned by foreign banks. All of the U.S. securities firms entered as subsidiaries (entry as a branch is only permitted for bank branches).

Since the initial sharp increase in the number of foreign bank-owned money market corporations in the mid-1980s, the industry has been engaged in rationalization process — both in terms of the number of institutions and the size of assets. A number of departures reflected decisions by certain foreign banks to withdraw from overseas operations, as well as poor returns resulting from difficult economic conditions in Australia in the late 1980s and early 1990s.

In addition to MMCs, nonbank financial intermediaries (NBFIS), which include credit unions, building societies (savings and loans), and finance companies also operate in Australia's capital markets. As of year-end 1993, MMCs and other nonbank financial intermediaries accounted for just under 24 percent of total financial assets among Australian financial intermediaries.

Market Regulation

While both the ASX and the SFE maintain "rules of conduct" for participants, neither exchange is formally a self-regulatory organization (SRO). The sole securities regulatory body is the Australian Securities Commission (ASC), which administers the Corporations Law. Regulation applies to both securities and to futures products. The ASC's status as sole regulator applies at both the federal and the state level.

The ASC maintains a dealer licensing system for all participants in the securities markets. Applicants generally apply for the type of standard license that best fits their activities.

There are no foreign exchange controls. Funds can be sent anywhere except for "tax havens." For individuals, foreign investment funds over A$50,000 are subject to a tax. There are no controls on Australian residents issuing securities abroad. Nor are there any controls on nonresidents investing in Australian equities or fixed-income instruments.

U.S. PRESENCE IN THE MARKET

U.S. financial institutions provide services that include charge card and travel services, funds management, foreign exchange, futures, currency swaps and options, lending, leasing, dealing and broking securities, and financial advising. U.S. firms operate as fully integrated members of the industry. They have seats on the Australian Stock Exchange, nondiscriminatory access to reserve bank officials, and nondiscriminatory membership in the Australian Bankers association.

Merrill Lynch International (Australia) Ltd. has received permission from the RBA to operate, through a wholly-owned subsidiary, as an authorized money market dealer company. As one of ten RBA authorized dealers, Merrill Lynch will be a company with whom the RBA will conduct its market operations in Commonwealth Government Securities with a short-term maturity (less than one year). Merrill Lynch joins CS First Boston, which has similar status.

As of April 1994, foreign banks owned 65 of the 88 registered MMCs. U.S. banks own 14 of these. Foreign bank-owned MMCs, which currently account for about 80 percent of industry assets, lend mainly to major Australian corporations, local subsidiaries of multinational corporations, and Australian companies expanding offshore. Some MMCs have placed more emphasis on Treasury and fee-based activities.

Thus far, no foreign bank has shown any interest in obtaining an equity stake in any Australian credit union or a building society, but some foreign banks do operate as finance companies.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In general, foreign financial institutions can operate freely in all areas of financial services in Australia.

U.S. financial institutions believe that the government of Australia does not discriminate against foreign-owned financial institutions. U.S. firms are generally satisfied with regulatory procedures. No major problems were cited. However, some industry representatives expressed the view that more coordination in procedures was needed between the various regulators.

A potential area of concern regards the Foreign Acquisitions and Takeovers Act of 1975, which requires that foreign interests notify the FIRB before acquiring 15 percent or more of a

company's equity, for all transactions over AU$5 million. The FIRB is then authorized to withhold approval if it finds the transaction contrary to the national interest. In practice, the 1975 Act has not presented U.S. firms with significant difficulties.

U.S. firms mentioned taxation in Australia as too high and not as favorable for foreign firms as other tax regimes in the Asia-Pacific Region. No complaints were made, however, about discrimination in taxation.

Trends in Financial Intermediation Market Share
(percent of total assets at year-end)

	1989	1990[1]	1991	1992	1993
Banks	66.5	69.3	70.9	73.4	76.5
- Domestic Banks	59.1	61.9	63.2	68.5	68.1
- Foreign Banks	7.5	7.5	7.8	7.6	8.4
...of which U.S.-owned	2.6	3.2	3.2	3.1	3.6
Nonbank Financial Intermediaries	33.5	30.7	29.1	26.6	23.5
Money Market Corporations	11.5	9.5	9.0	8.8	8.2
...of which U.S.-owned	1.4	0.8	0.8	0.7	0.7
Finance Companies	10.5	9.9	8.5	7.8	7.4
...of which U.S.-owned	0.4	0.4	0.2	0.2	0.1
Building Societies	4.6	4.2	4.1	2.2	2.5
Credit Unions	1.7	1.7	1.9	2.0	2.3
Authorized Money Market Dealers	0.8	0.7	0.7	0.8	1.0
Other	4.4	4.6	4.8	5.0	2.2
Total Financial Intermediaries	100.0	100.0	100.0	100.0	100.0
...of which U.S. owned	3.0	3.7	3.4	3.3	3.7

[1]Data used for banks from 1990 is based on assets recorded on banks' Australian books; prior to this date, it is based on assets within Australia.
Source: The Reserve Bank of Australia

Exchange Rates

Average 1993:	US$1 = AU$1.49
End of year 1993:	US$1 = AU$1.47

CHINA

BANKING

SUMMARY

While China has made impressive strides over the past 15 years toward establishing a more market-based economy, its domestic banking system is still very heavily influenced by the legacy of the old planned economy. The primary purpose of the banking system continues to be to channel private savings to finance the state sector through loans that are often politically directed. The Chinese government has announced plans to convert the four "specialized" banks that dominate the domestic banking system into "commercial" banks by transferring their responsibilities for making noncommercial loans to three newly established "policy" banks. The Chinese government also intends to pass the PRC's first central and commercial banking laws by the end of 1994. In practice, however, creating a modern commercial banking system in China is likely to require a number of years to fully complete.

All aspects of the Chinese banking system are heavily regulated. The People's Bank of China sets interest and deposit rates, and overall bank lending is controlled administratively through the credit plan. Because a large share of lending by Chinese banks has traditionally been based on noncommercial criteria, these banks have little experience with credit analysis and their balance sheets contain many large problem loans, especially to inefficient state enterprises.

China's treatment of foreign financial institutions is highly restrictive. Foreign banks are not permitted to conduct local currency (renminbi) business and they may only participate in wholesale banking in such areas as letters of credit, export credits, and commercial loan syndications. Foreign banks may open branches and subsidiaries (joint ventures and wholly-foreign-owned), but only in 13 selected cities and special economic zones. Outside of these specified areas, banks may only open representative offices that cannot engage in any profit-making activities. Despite these restrictions, U.S. and foreign banks have steadily increased their presence in China over the past few years. Nine U.S. banks are represented in China, four of them by a total of six branches.

DESCRIPTION OF THE MARKET

The banking sector in the People's Republic of China is dominated by a small number of large state-owned banks. The People's Bank of China (PBOC), China's central bank, has overall responsibility for supervision of the banking sector. Below the PBOC are four major specialized banks and nine commercial banks. China's specialized banks have amassed 90 percent of the credit funds of the entire banking system and have undertaken 75 percent of China's deposit-taking and credit-granting business.

Specialized Banks

Each of the four major specialized banks originally concentrated on providing financial services to a specific economic sector, but in recent years these distinctions have diminished as the specialized banks have broadened the scope of their business activities. Nevertheless, the Industrial and Commercial Bank of China (ICBC), the largest of the specialized banks, still extends working capital loans primarily to state enterprises and loans to the state sector for fixed asset investment. The Agricultural Bank of China (ABC) provides financial services in rural areas, including managing payments for crop procurement by the state. The People's Construction Bank of China (PCB) offers medium- and long-term financing to capital construction projects, and the Bank of China (BOC) remains the PRC's main international and foreign exchange bank. The China Investment Bank (CIB) is a relatively small, specialized bank that raises construction funds abroad and acts as an intermediary for World Bank lending.

The concentration of China's financial resources in the state-owned banks has ensured that state-owned enterprises have enjoyed preferential access to formal credit. As subsidies and other government expenditures have been moved off budget in the past decade, the banking system has become an increasingly important conduit for quasi-fiscal financing to the state sector. Though nonstate enterprises are generally more efficient, official policies have discouraged state banks from providing them with credit in proportion to their increasing weight in the economy. Less than 20 percent of outstanding bank loans have gone to the nonstate sector, even though their share of national industrial output now exceeds 50 percent.

Plans have been developed to convert China's specialized banks, which currently carry large segments of state directed policy lending on their books, to commercial banks. To accomplish this, China established three new "policy banks" in 1994. The Import-Export Bank will help finance major trade deals, the State Development Bank will fund infrastructure projects, and the Agricultural Development Bank of China will fund agricultural procurement and rural development. While the establishment of these new banks is a potentially important reform, specialized banks still remain responsible for providing directed "working capital" loans to financially troubled state enterprises — in many ways the most problematic of their current policy lending activities.

Commercial Banks

Also under the supervision of the People's Bank of China (PBOC) are nine commercial banks, of which the Bank of Communications and the CITIC Industrial Bank are by far the most important. The total assets of the commercial banks, some of which are collectively owned or are joint-stock enterprises, was over 200 billion renminbi (RMB) at the end of 1992.

Assets, Liabilities, Deposits, and Loans of Major Chinese Specialized and Commercial Banks, Year-End 1992

(in billions of RMB)

	Total Assets	Total Loans	Total Liabilities	Total Deposits
ICBC	1,433.7	933.7	1,363.2	796.2
BOC	1,422.1	496.6	1,358.9	612.1
PCBC	816.4	345.3	816.4	323.6
ABC	868.1	546.8	833.6	413.1
BoComm	157.0	73.5	145.9	93.5
CIB	24.1	15.9	22.0	6.1
CITIC IB	33.6	19.4	32.2	19.9

Sources: Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), People's Construction Bank of China (PCBC), Agricultural Bank of China (ABC), Bank of Communications (BoComm), the China Investment Bank (CIB), The China International Trust and Investment Corporation (CITIC IB).

Nonbank Financial Institutions

The number of nonbank financial institutions has been expanding in China in recent years. The China International Trust and Investment Corporation, established in 1979 to raise foreign currency funding for projects in China, was the first, and with RMB 51 billion in assets at the end of 1992, by far the largest. Many other trust and investment companies (TICs) have been set up since at national and local levels. Their main business is to receive government agency and enterprise trust deposits and entrusted deposits. Finance companies are formed by industrial and commercial conglomerates to facilitate intragroup financing. Leasing companies are primarily engaged in leasing imported capital goods to export-oriented enterprises. There are currently 377 trust and investment companies, 66 securities companies, 22 financial companies (all established after 1986), 9 leasing companies, and 3 insurance companies in China. The nonbank financial institutions are more autonomous and profit-driven and have introduced a limited degree of competition into the financial sector.

Rural and Urban Credit Cooperatives

Finally, China's financial system includes a vast network of rural credit cooperatives (RCCs), with over 286,000 branches and savings offices nationwide. Rural credit cooperatives are in principle owned collectively by their depositors, but in practice they are under the guidance of the Agricultural Bank of China and enjoy little autonomy in management and lending decisions. RCCs extend credit to individuals and are an important source of financing for rural township and village enterprises. By the end of 1992, China's RCCs had total assets of RMB 487.4 billion and total liabilities of RMB 437.1 billion. Urban cooperatives play a smaller role. The total number of China's urban credit cooperatives reached over 4,000 by the end of 1992, with total assets of over RMB 79 billion.

Market Regulation

The People's Bank of China is the only government agency with authority to supervise, regulate, and inspect China's financial institutions. The PBOC has units responsible for bank supervision at each of its branch offices at the provincial and city level, as well as at many of its county level branches. As part of its planned central bank reforms, China hopes to strengthen the PBOC's auditing staff, especially at the headquarters level, and to enact comprehensive central and commercial banking laws that will provide a clearer legal basis for the PBOC's supervisory activities.

Under China's traditional planned economic system, the main purpose of bank regulation was to ensure that loans were made to priority sectors and bank branches adhered to the credit plan. Chinese regulators have therefore placed little emphasis on prudential regulation intended to control risks and maintain the overall soundness of the financial system. Most supervisory activity is still directed at regulating the local branches of the large specialized banks, rather than at a more centralized level where systemic risks are likely to be greater. China has begun, however, to implement reforms aimed at strengthening the PBOC's ability to supervise the banking system. In February of this year, the PBOC issued new supervisory guidelines requiring all banks to apply new credit control procedures designed to bring China in line with the risk weighted capital adequacy guidelines established in the Basle agreement.

All interest rates on deposits and loans are set administratively by the central government. The complete schedule of interest rates fills a small book, with dozens of preferential lending rates being set to encourage various sectors of the economy. During the period of reform since 1979, real interest rates on savings deposits have generally been kept positive, encouraging a high rate of financial saving. The result has been a significant deepening of China's financial sector. Broad money (M2) increased from just 37 percent of China's GDP in 1979 to over 100 percent in 1992. As inflation accelerated in 1993, the PBOC raised interest rates in May and again in July, when indexing was reintroduced on savings deposits of more than three years. Since mid-

1993, real interest rates have been negative but private savings deposits have nonetheless increased at a rapid rate.

U.S. PRESENCE IN THE MARKET

Foreign financial institutions began returning to China in the late 1970s and began setting up representative offices, mainly in Beijing, starting in 1980. Chinese-owned banks based in Hong Kong (e.g., Bank of Kwangtung, Nanyang Commercial Bank) were the first foreign-registered banks to set up branches in the Shenzhen Special Economic Zone. By the end of 1992, foreign financial institutions had set up 231 representative offices and 70 business offices. By the end of 1993, the numbers had increased to 302 representative offices and 98 business offices. With assets totalling $8.1 billion, the foreign funded banks granted $4 billion of loans (77 percent to domestic enterprises) and received $4.2 billion in savings deposits, according to official Chinese statistics.

Wholesale banking and trade finance are the market staples for U.S. banks in China. Primarily through their branches located outside of China, U.S. banks handle letters of credit and funds transfers, arrange or participate in U.S. or other export credit programs, participate in joint ventures in commercial banking and leasing, provide financial advice for major projects, trade currency and bonds with Chinese banks, manage foreign currency funds for Chinese entities, and arrange and participate in commercial loan syndications.

Foreign currency activities permitted foreign bank branches within China include loans, deposits, discount bills, investment, remittances, guarantees, import and export settlement, transactions between foreign currencies, agency for payments against credit cards, safe deposit boxes and credit investigation. Foreign banks generally may only accept deposits from other foreign-invested firms (e.g., joint ventures) and foreign individuals. Chinese enterprises are not allowed to make deposits at a foreign bank from which they have not received a loan. Foreign currency loans made to Chinese firms are subject to the approval of the People's Bank of China and the Office of State Administration of Exchange Control. Representative offices, which may be established in any Chinese city open to foreigners, may not engage in profit-making activities, but often help facilitate these activities on behalf of the banks.

Bank of America has branches in Shanghai and Guangzhou, Citibank has branches in Shanghai and Shenzhen, and Chase Manhattan recently became the first American bank to open a branch in Tianjin. An American joint-venture bank, Bank of the Orient, has a branch in Xiamen as well as a representative office. American commercial banks with representative offices in China are: Chase Manhattan, Citibank, Bank of America, Bankers Trust, First National Bank of Chicago, Chemical Bank, Republic National Bank of New York, American Express Bank, and the Far East National Bank. In addition, numerous other American banks do substantial business in China from offices in Hong Kong, Tokyo, and the United States.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks in China face substantial restrictions on the scope of their business activities in China. The most fundamental are: their inability to conduct business in local currency, the geographical restrictions on where they can establish, and restrictions that prevent Chinese firms from opening accounts at foreign banks. The general lack of regulatory transparency, common to almost all sectors of the Chinese economy, also plagues the foreign banking industry.

In a Joint Declaration issued during Treasury Secretary Bentsen's January 1994 visit to Beijing, China agreed to expand the number of areas that would be open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis. While these commitments represented welcome progress, Chinese authorities have so far not taken any steps to implement them, and more recently have temporized their earlier commitment with an indication that foreign banks will not be permitted to do local currency business until the renminbi is fully convertible.

In 1992, China liberalized its rules regarding permissible locations for foreign branch banking, but branch openings are still heavily controlled. Eight cities -— Shanghai, Dalian, Tianjin, Qingdao, Nanjing, Ningbo, Fuzhou, and Guangzhou — and five special economic zones — Shenzhen, Zhuhai, Hainan, Xiamen, and Shantou — are now open to foreign commercial bank branches. Investment banks are still restricted from opening branches.

Branch approvals are subject to capital requirements and licensing approvals. Banks must have had a representative office in China for at least two years to be eligible to open a branch. Branch banks are required to have RMB 100 billion ($11.5 million) in capital, of which 30 percent must be deposited in an interest bearing account with the PBOC. U.S. bankers note that this substantially restricts the branches' liquidity. They also complain that other de facto conditions, such as a track record of "contributions to China," lack transparency and are politically motivated.

Staffing is another critical issue, especially for the representative offices of U.S. banks. While branch offices can recruit directly, representative offices have to mandatorily hire through a Chinese government agency, FESCO, that retains 55 percent of the annual gross salary paid to a Chinese employee as a fee. This inhibits the recruiting of highly qualified employees and increases the salary costs of representative offices, because they routinely have to provide additional compensation to employees.

The frequent, and often arbitrary, intervention of the office of State Administration of Exchange Control (SAEC) imposes a further burden on U.S. banks. Since U.S. banks' business scope in China is restricted to foreign exchange business, SAEC approval is required for almost all of their activities. Particularly troublesome is that the SAEC informs joint ventures that their accounts with foreign banks are initially approved for only two years on a renewable basis.

While renewals never seem to be a problem, the uncertainty may lead many joint ventures to open accounts instead with the BOC whose SAEC approvals seem not to require renewal. Additionally, approval requests made by joint ventures to open accounts in foreign banks appear routinely to take longer for SAEC approval than do requests for accounts in Chinese banks. Once a joint venture obtains approval from the SAEC, it is free to open as many foreign exchange accounts with Chinese banks as it chooses, but it must receive specific SAEC approval for each account opened at any foreign bank.

Foreign banks may now become members of China's Foreign Exchange Trading Centers. While they may buy and sell foreign exchange on behalf of joint ventures, they are prevented from selling foreign exchange to Chinese customers, placing them at a considerable competitive disadvantage.

Financial Policy Discussions

The Treasury Department is actively seeking an expanded role for foreign financial institutions in China, in the context of an ongoing bilateral dialogue and, in 1994, in the context of China's bid to join the GATT/WTO. As described above, the scope of permissible activities for foreign bank branches in China is very limited. The Treasury Department has been pressing the Chinese government to allow foreign financial institutions to establish in additional cities, to engage in local currency business, and to serve Chinese clients.

These issues have taken an increasing high profile since Secretary Bentsen's January 1994 visit to China. In the Joint Declaration issued by Secretary Bentsen and Finance Minister Liu at the end of the meeting of the Joint Economic Committee, China agreed to expand the number of areas open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis.

These commitments represented welcome progress. However, in the months since then, the Chinese authorities have not taken any steps to implement them, and more recently have indicated that foreign banks will not be permitted to do local currency business until the renminbi is fully convertible.

In 1994, China's application to enter the GATT/WTO, including its financial services offer, has come under intense review. In these negotiations, Treasury is asking China to make commitments to provide substantially full market access and national treatment for foreign financial institutions. These objectives could be achieved in accordance with a timetable for implementation of specific liberalizing measures, including the commitments made to Secretary Bentsen in January 1994.

CHINA

SECURITIES

SUMMARY

Although still in their infancy, the reestablishment of securities markets in China has been the most dramatic recent aspect of China's financial reforms. After a hiatus of more than 40 years, the Shanghai Securities Exchange reopened on November 26, 1990, and on July 3, 1991, Shenzhen, in China's southeastern Guangdong province, opened the country's second exchange.

Partly because the equity market is so new, China's regulatory structure is still in flux. Overlapping agencies with ill-defined responsibilities make the regulatory process unclear. At present, interim regulations issued by the State Council in May 1993 govern the activities of domestic investors, but there is still no law explicitly covering the presence or activities of foreign firms. Foreign firms comment that this lack of transparency of regulations represents a significant problem.

Foreign securities firms may establish representative offices, but they cannot establish local branches or subsidiaries. Foreign firms may purchase seats on both the Shanghai and Shenzhen exchanges to broker "B" shares (explained below), but they must work with domestic brokers for all of their transactions on the basis of a shared commission. Foreign firms cannot underwrite local securities issues or act as dealers or brokers in RMB denominated securities. U.S. firms' major involvement in China is in underwriting offshore equity and bond issues for domestic companies. However, each offshore issue must receive prior approval from the government.

Publicly offered stocks are segregated into two types of shares: "A" shares and "B" shares. "A" shares are issued by Chinese companies for sale exclusively to Chinese individuals and Chinese legal persons. "B" shares, which are denominated in Renminbi (RMB) but must be purchased with foreign currency, are issued by Chinese companies for sale exclusively to non-Chinese. The combined aggregate capitalization of equity securities on both markets as of April 1994, was approximately RMB 391 billion ($45.0 billion). Aggregate market capitalization of shares available for purchase by non-Chinese as of April 1994, was approximately $1.95 billion ("B" share statistics are reported in U.S. dollars).

DESCRIPTION OF THE MARKET

China's equity market has grown rapidly since its reopening in November, 1990. The Shanghai Exchange opened with 46 seats and two trading counters. At the end of its first full year of operation total trading turnover on the Shanghai Exchange was RMB 11 billion. By the end of 1992, there were 73 listed securities and turnover was RMB 65 billion. As of December 1993, there were 163 listed shares traded in Shanghai and 2,554 seats on the exchange.

Similar growth has occurred on the Shenzhen Exchange. At the end of 1992, 33 shares were traded and total trading volume on the exchange amounted to RMB 43.8 billion. Currently, 76 shares are traded on the Shenzhen Exchange.

Chinese companies seeking to issue shares must undergo different levels of review by the People's Bank of China (PBOC), the China Securities Regulatory Commission (CSRC), and the State Commission for Restructuring the Economic System (CRES). Companies seeking to issue "B" shares must be limited liability share-holding companies that have been profitable for at least two consecutive years, possess sufficient foreign exchange revenues to pay dividends and cash bonuses, and provide financial statements and earnings forecasts for three consecutive years. The price to earnings ratio must be below 15 at the time of listing.

Foreign investors seeking to purchase "B" shares must open an account with a foreign clearing house through an approved foreign broker. The overseas broker can then pass customers' orders to traders on the exchange floors or to a related local broker. In Shanghai all qualified domestic brokers can now trade "B" shares. Eighty "franchise B share brokers" currently trade in Shenzhen, of which 10 are foreign firms. All orders are executed in the central order matching system in either market. In Shenzhen, settlement takes place three days after the day of trade. In Shanghai, to increase market liquidity, the exchange replaced the T+3 rule with a T+0 rule. Off-market trading and short selling are not allowed in either market.

In addition to the two officially recognized exchanges, there are "securities exchange centers" in 18 of China's larger cities and two electronic trading systems, the National Electronic Trading system (NET) and the Securities Trading Automated Quotation system (STAQ). Trading at "securities exchange centers," in Wuhan, Shenyang, Tianjin, and other cities, is limited to government and corporate bonds only.

NET and STAQ provide secondary markets for "legal person shares" — corporate shares that can be traded by China's "registered legal persons," mostly government agencies and state-owned enterprises. The STAQ system, established July 1, 1992, trades 10 "legal person issues" with a total volume of 639 million shares. NET was established April 28, 1993, and trades 554.5 billion shares of seven listed companies. Many companies are reportedly waiting for approval to list on the NET and STAQ system.

In 1993 and 1994, China's "A" share market has remained volatile. Shanghai's "A" share index tumbled 20 percent in September and early October 1994 with analysts attributing the fall to profit taking and concerns about rising inflation. Shanghai's "A" share index fell to a low of 328.85 at the end of July 1994. This prompted China's Securities Regulatory Commission (CSRC) to convene an emergency session the weekend of July 30-31. The Commission announced several measures to boost public confidence in the stock market. These measures included: (1) canceling all "A" share listings scheduled for 1994 until the end of the year,(2) announcing the authorities' intention to gradually allow foreign institutional investors to buy "A"

shares, (3) encouraging the development of mutual funds, and (4) tightening control over rights issues. However, the authorities appear to have backed away from opening the stock market to foreign investors in the near term as the "A" share index has rebounded. Moreover, the measures announced by the CSRC do not address other underlying problems in the stock markets including: lack of standard accounting practices, shortage of information, and the perception of poor management.

Initial reaction to the opening of China's securities markets to foreign investors in the form of "B" shares in 1991 was frenzied buying. In the first half of 1992, 20 China funds were launched, raising more than $1 billion for investment in both listed and unlisted companies. Most of the initial "B" share issues were many times oversubscribed. In mid-May 1992, after share prices reached more than 200 percent above their initial listing price, the market plunged. Demand has been variable throughout 1993 and 1994.

Prices of Shenzhen "B" shares have generally outpaced those in Shanghai, but both markets have been volatile in this period of consolidation. The relatively weak demand for "B" shares is attributable to China's nonstandard accounting practices, the shortage of information on listed companies, and the variety of alternative China investment strategies available to foreign investors. In an attempt to address the former concerns, the CSRC issued provisional regulations in 1993 requiring all "B" share companies to issue annual reports audited by certified accountants. As of August 1993, only five of the 12 companies with listed "B" shares in Shanghai, and only one in Shenzhen, had published the required report. As a result, many foreign investors have chosen to invest in China indirectly through Hong Kong and other Asian companies with major investment and trading interests in China, through more than two dozen Hong Kong-listed "red chips" — companies primarily owned by mainland interests, or through "H" shares — Hong Kong listings of mainland companies. In 1993, nine Chinese state enterprises were selected to float "H" shares in Hong Kong, 22 others have been selected to list in 1994. Other investors chose to buy American Depository Receipts (ADRs) of five Chinese companies listed on the New York Stock Exchange.

Funds Management

China does not have a domestic mutual funds market yet, perhaps because the overwhelming majority of investors trade on their own account. Foreign banks may not sell foreign mutual funds or any other form of foreign securities to Chinese citizens or institutions.

Pension fund development is moving forward in China. Foreign banks might be allowed to manage domestic pension funds in the future, but at present all pension funds remain under government control.

Regulatory Structure

Prior to August 1992, the State Council's Securities Committee and the People's Bank of China were the primary securities market regulatory authorities. The PBOC was responsible for overseeing local Shanghai and Shenzhen regulatory authorities. On August 10, 1992, rioting erupted in Shenzhen among domestic investors anxious to buy public issues. The Shenzhen riot forced the Beijing authorities to come to terms with the lack of effective market regulation and to establish a two-tier structure to oversee policy-making and day-to-day regulation.

The State Council Securities Policy Commission (SCSPC) was set up under the chairmanship of Vice Premier Zhu Rongji to establish policy and to determine the number of listings and the volume of issues. The China Securities Regulatory Commission (CSRC), an executive agency of the State Council, was established to supervise and regulate the markets. The CSRC, which has offices in Beijing, Shanghai, and Shenzhen, designates firms for listing and licenses brokerage companies.

Despite the establishment of the CSRC, China's securities regulatory system still lacks clarity and is still plagued by overlapping responsibilities between competing agencies. The PBOC maintains overall responsibility for the registration of securities firms and traders, and the State Planning Commission (SPC) and the Ministry of Finance (MOF) still retain some oversight responsibilities. The State Administration of Exchange Control, a division of the PBOC, is in charge of transactions involving foreign exchange, including dividend payments on "B" shares.

Over the past year, the Financial and Economic Committee of the National People's Congress (NPC) drafted national regulations for China's securities markets. But differences over key provisions of the law, including the responsibilities of national and local regulatory bodies, have delayed final passage of this important legislation. Chinese officials are hopeful that the Securities Law will be concluded in the second half of 1994, but until then securities markets will continue to be regulated by interim rules issued by the State Council in May 1993, the Regulation on the Administration of the Issue and Trading of Securities in China. The interim regulations govern only the activities of domestic investors in securities. The Securities Law is now awaiting approval from the State Council, but recent indications are that a consensus on the draft is still distant.

U.S. PRESENCE IN THE MARKET

A number of U.S. securities firms have opened representative offices in China. In March 1993, Merrill Lynch opened a Shanghai representative office, the first foreign securities company to operate in China. Many U.S. investment firms quickly followed. In August 1993, CS First Boston (HK) Ltd. opened the first office of a foreign securities firm in Beijing. Morgan Stanley, Lehman, Solomon, Goldman Sachs, J.P. Morgan, and Bear Stearns also have opened representative offices in China. In October 1994, Morgan Stanley and the People's Construction Bank of China agreed to establish China's first joint venture investment bank.

In May 1993, the Shanghai Securities Exchange offered an additional twenty seats to foreign brokerages. This brought the total number of foreign brokers seated on the Shanghai Exchange to 23. Foreign securities firms in Shanghai may only conduct trades in "B" shares through domestic brokers on shared commission. In August, Shenzhen offered eight special seats to overseas brokers to deal directly in "B" shares, but clearance and settlement still must go through a local sponsoring broker. The membership fee for a special seat is RMB 1 million (about $115,000), the same fee paid by local brokers.

The primary involvement of U.S. securities firms in China has been through the preparation and underwriting of international offerings. On October 9, 1992, China Brilliance Automotive Holding (CBA), a Chinese bus maker, made its debut on the New York Stock Exchange, becoming the first Chinese based enterprise to list abroad. The CBA issue was lead-managed by CS First Boston and U.S. legal and accounting firms were heavily involved in its preparation. China Tire Holdings and Shanghai Petrochemical followed suit in July 1993. U.S. securities firms have secured many international underwriting deals involving Chinese debt or equities. For example, Merrill Lynch & Co. has won more than a dozen China-related underwriting assignments worth more than $1.31 billion since 1992. CS First Boston, another pioneer in the China market, has lead-managed issues totalling $1.5 billion.

Introduction of new domestic financial products is prohibited, but offshore derivatives is an attractive business for foreign banks operating in China.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Although U.S. firms have competed successfully for many of China's overseas underwriting deals, within China their business continues to be severely restricted by discriminatory regulations and lack of market transparency. Foreign securities firms cannot establish local branches or subsidiaries. They may establish only representative offices. Representative offices are limited to offshore activities and, for stock exchange members, to transactions in "B" shares only.

Foreign firms are required by Chinese regulations to hire their Chinese staff through an "approved labor supplier." Subsidiaries, branches, and joint ventures are not governed by the same rules and may recruit employees directly.

Establishment of representative offices of all foreign financial institutions, including investment banks, is subject to the Regulations Governing Representative Offices by Foreign Financial Institutions, which was promulgated by the PBOC in 1990. A firm seeking to open a representative office applies to the PBOC, which then must consult with other interested agencies and local government offices before issuing its approval. Opening a representative office, as opposed to a branch or subsidiary, is generally a relatively straightforward process, and apparently there are no current significant problems.

Even though foreign securities firms may open only representative offices in China, they can participate in "B" share brokerage business and have seats on exchanges. However, they cannot underwrite "A" shares, government securities, or nongovernment bond issues, nor can they purchase or act as dealers in the secondary markets for any form of RMB denominated security. In Shenzhen, a limited number of foreign firms were permitted to purchase seats on the exchange, but their trades must still be cleared and settled through a sponsoring local broker. In Shanghai, foreign firms also may purchase exchange seats, but they must enlist domestic brokers to conduct "B" share trades, and they must share commissions.

Foreign firms may underwrite international equity and bond issues, but approval by the State Council, granted for 22 large state-owned companies this year, is required before any domestic enterprise may list securities in an overseas market. Residents may not invest overseas without government approval, which eliminates an area of securities business in which U.S. securities firms are traditionally strong. For capital account purposes, the Chinese currency is not convertible.

China still has not passed a national securities law. Official press commentary on the law regularly espouses reform of the securities sector, particularly opening "B" share sales to domestic investors or eliminating the "B" share market entirely. There is no indication that such moves are imminent.

China's existing securities and accounting regulations lack transparency, although timeliness of notification of changes has improved during the past year. Lack of enforcement of settlement payment procedures and insufficient requirements on disclosure of information by listing companies also increase the risk of foreign investors and brokers. Regulations mandating capital gains tax on investment income have been promulgated, but have not been enforced and will probably not be enforced this year for either domestic or foreign investors.

Repatriation of profits requires government approval, but this is generally a formality. Dividend payments on "B" shares do not require special approval.

Despite these restrictions, and the still relatively underdeveloped state of the Chinese securities market, most U.S. securities firms remain optimistic about the longer-term prospects for the Chinese market. They note that progress has been made in the past two to three years both with regard to domestic exchanges and the introduction of companies to overseas markets, and they remain hopeful that conditions for doing business will improve significantly as further securities market reforms are introduced over the next few years.

Financial Policy Discussions

In numerous bilateral and multilateral discussions, including in the context of China's application to enter the GATT/WTO, Treasury has sought significant liberalization of China's securities

market including permission for foreign financial institutions to participate in the underwriting and trading of renminbi-denominated securities. China has been reluctant to make meaningful commitments and despite the optimism noted above, there are no indications that China will soon allow an expanded role for foreign securities firms in the Chinese market. Much work remains to be done, especially as commitments in the securities area would make a positive contribution to China's GATT/WTO accession commitments.

HONG KONG

BANKING

SUMMARY

Sustained regional prosperity, the attendant accumulation of wealth, and China's rapidly expanding need for capital to finance its fast-growing economy contributed to the robust development of Hong Kong's financial sector during the 1990s. Hong Kong serves as a gateway to China and as a regional center for foreign financial institutions. More than 60 percent of the assets and liabilities in Hong Kong's banking sector are external. Its foreign exchange and gold markets are an integral part of global markets.

Hong Kong has a three-tier system of deposit-taking institutions: licensed banks, restricted license banks, and deposit-taking companies. Only licensed banks can offer current (checking) or savings accounts. All banks are required to become members of the Hong Kong Association of Banks and observe rules made by the association. The association has recently announced a timetable for deregulation of time deposits that are currently under interest rate rules.

Although the territory has no central bank, the Hong Kong Monetary Authority assumes many of the normal central banking functions. It is responsible for maintaining stability of the financial system and managing the Exchange Fund backing Hong Kong's currency, which is currently linked to the U.S. dollar at HK$7.8 = US$1, as well as ensuring the safety and soundness of the financial banking system, including regulating banks. The Hong Kong & Shanghai Banking Corporation (HKBC) is the territory's largest banking group. It is estimated that the group, with its majority-owned subsidiary Hang Seng Bank and 340 branches, controls more than 40 percent of Hong Kong dollar deposits. HKBC, Standard Chartered Bank, and the Bank of China are the territory's three note-issuing banks. Hong Kong has no system of deposit insurance. Under guarantees provided by the Basic Law, promulgated by China in 1990, Hong Kong's monetary and financial regulatory structure will remain autonomous when Hong Kong becomes a Special Administrative Region of China in 1997.

At year-end 1993, there were 371 authorized institutions and 142 local representative offices of foreign banks in Hong Kong, of which 41 were U.S. authorized institutions or local representative offices. This figure included 14 of 172 licensed banks, 8 of 57 restricted license banks, 11 of 142 deposit taking companies, and 8 local representative offices. U.S. institutions held 5 percent of total assets of US$783 billion, 4 percent of total loans of US$366 billion, and 7 percent of total deposits of US$221 billion.

There are no barriers to foreign bank branch operations in Hong Kong, except that overseas banks granted licenses after 1978 may maintain offices in only one building. In September 1994, this limitation was modified to permit foreign banks to set up a regional office and a back office operation at buildings separate from the branch office. Automated teller machines for banks granted licenses after 1978 also are subject to the regulation. Foreign banks cannot

establish as wholly-owned subsidiaries, due to the licensing criteria that the applicant should be predominantly beneficially owned by Hong Kong interests. However, foreign banks may acquire a controlling interest in a local bank, which has unlimited branching rights. U.S. banks indicate they generally view Hong Kong as one of the most open, transparent, and fair markets in which to do business in Asia.

DESCRIPTION OF THE MARKET

Hong Kong is the world's 10-largest merchandise exporter and the principal conduit for trade and capital flows to and from China. Services account for 76 percent of GDP, which reached US$109.6 billion or US$18,500 per capita in 1993. Laissez faire economic policies, complete freedom of capital movement, low taxes, modern infrastructure, and a well-understood regulatory and legal environment have propelled Hong Kong's entrepôt economy. Eighty-one of the world's top 100 banks operate in the territory. There were also 142 local representative offices of overseas banks at the year-end 1993. External assets of the banking sector were fourth-largest in the world in 1993 behind the United Kingdom, Japan, and the United States. Foreign exchange turnover was the sixth-largest.

Hong Kong is the gateway to China. Geographic proximity, plus cultural and linguistic ties, particularly with neighboring Guangdong Province, have had a synergistic effect on the development of the two economies in the run-up to Hong Kong's reversion to Chinese sovereignty on July 1, 1997. Hong Kong is China's "front-office" service center, supplying PRC enterprises with financial resources and expertise, shipping services and marketing. The territory is the most important source of external direct investment in China, accounting for an estimated 70 percent of the total. According to the IMF, Hong Kong-based investors signed letters of intent for over US$100 billion in investment in Chinese projects in the three years through 1993. Hong Kong manufacturers have taken full advantage of China's lower cost of land and labor resources in shifting their manufacturing operations to the PRC.

The Hong Kong Stock Exchange's role in raising equity capital for PRC enterprises has attracted a large foreign investment banking presence, and the territory has become an important center for loan syndications and international fund management. Over the 10-year period from 1982 to 1991, the gross output and value added of the financial sector at current prices grew from US$2.4 billion and US$1.7 billion, respectively, to US$9.7 billion and US$6.6 billion in 1991. More recent figures are not available.

Since 1983, the Hong Kong dollar has been linked to the U.S. dollar at a rate of HK$7.8 = US$1. Bank notes are issued by the HSBC, Standard Chartered Bank and, beginning May 1, 1994, the Bank of China. Note-issuing banks are required to deposit U.S. dollars at the fixed exchange rate in an amount equivalent to the value of Hong Kong currency notes issued. Note-issuing banks receive non-interest-bearing certificates of indebtedness from the Exchange Fund in return.

The Sino-British Joint Declaration, signed in 1984, and the Basic Law, promulgated by China in 1990, form the legal basis for China's "One Country, Two Systems" guarantees for Hong Kong when it becomes a Special Administrative Region of China in 1997. The Basic Law guarantees the rights and freedoms that Hong Kong residents now enjoy, the continued rule of law, and the maintenance of Hong Kong's capitalist system for 50 years. Defense and foreign affairs will be under the direct control of Beijing, but the free flow of capital will be retained. Hong Kong will, on its own, formulate monetary and financial policies, and will have independent finances using revenues exclusively for its own purposes. The Hong Kong dollar will continue to circulate as the legal tender of the region and be freely convertible. Markets for foreign exchange, gold, securities, futures, and the like will continue to operate. Systems currently in place, including Hong Kong's regulatory and supervisory structure, will remain unchanged.

Structure of the Banking System

Hong Kong maintains a three-tier system of deposit-taking institutions, collectively known as authorized institutions. These include licensed banks, restricted licensed banks, and deposit taking companies. Total deposit liabilities of all authorized institutions at the end of 1993 were HK$1,723 billion (US$221 billion). All banks are required to become members of the Hong Kong Association of Banks and observe rules made by the association.

According to Hong Kong's Banking Ordinance, licensed banks can perform all banking services, and have the exclusive right to offer current (checking) accounts and savings accounts. At the end of 1993, Hong Kong had 172 licensed banks (including banks incorporated both in Hong Kong and overseas) operating 1,433 branches, for a total of 1,605 offices. Thirty-two were locally incorporated, operating roughly two-thirds of the total branches. Deposit liabilities of licensed banks to customers at year-end 1993 totalled HK$1,676 billion (US$215 billion).

Locally incorporated applicants for banking licenses are required to have paid-up capital of HK$150 million (US$19.3 million) plus a minimum of 10 years experience in taking deposits and granting credit. Minimum assets (net of contra items) must equal or exceed HK$4 billion (US$512.8 million) and public deposits must equal at least HK$3 billion (US$384.6 million).

Restricted license banks engage primarily in merchant banking and capital market activities. They are not permitted to conduct retail operations. Licenses are granted at the discretion of the Financial Secretary. Restricted license banks may use the word "bank" to describe their business, but this must be qualified by adjectives such as "restricted license," "merchant," or "investment." The minimum paid-up capital requirement is HK$100 million (US$12.8 million). These institutions also must meet criteria regarding ownership, general standing, and quality of management. They can accept deposits of any maturity of sums not less than HK$500,000. At the end of 1993, there were 57 restricted license banks with total deposit liabilities to customers of HK$29 billion (US$3.7 billion).

Deposit taking companies have a minimum capital requirement of HK$25 million (US$3.2 million). They are restricted to taking deposits of HK$100,000 (US$12,800) or more with an original maturity of at least three months. At the end of 1993, there were 142 deposit taking corporations with total liabilities to customers of HK$17 billion (US$2.2 billion). Along with banks, they are increasingly diversifying into other financial services, including securities, fund management and providing investment advice.

HSBC, including its 61-percent-owned subsidiary Hang Seng Bank, remains the largest bank group in Hong Kong, with a combined network of 364 branches. It controls an estimated 40-plus percent of Hong Kong dollar deposits and is the management bank of the clearing house of the Hong Kong Association of Banks. It alternates the chairmanship of the association with Standard Chartered, which has 114 branches in the territory. The Bank of China Group is the second-largest bank group. The group's 13 member banks have a network of 360 branches in Hong Kong and control an estimated 23 percent of Hong Kong dollar deposits. The Bank of China, HSBC, and Standard Chartered are members of the Banking Advisory Committee and officials from all three institutions are on the Exchange Fund Advisory Committee (see Regulatory Framework section below).

Hong Kong banks have enjoyed healthy profits in recent years. Published results of publicly listed banks in the territory indicate after-tax profit growth of between 20 and 50 percent in 1993. Bad debt charges as a percentage of loans fell to 0.12 percent in 1993 compared to 0.15 percent in 1992. Hong Kong's booming economy and buoyant stock market contributed to this outstanding performance. Interest rate spreads also were healthy. The average spread between Hong Kong's best lending, or prime rate, and the three-month Hong Kong Interbank Offered Rate (HIBOR) was 3.1 percent, while the margin between the prime lending rate and the savings deposit rate remained at 5 percent.

Locally incorporated Hong Kong banks are not currently required to publish information relating to loan quality, level of bad debt provisions, the amount of nonperforming loans, or inner reserves. Inner reserves provide a pool of funds that a bank can draw from in order to smooth out performance. Thus, published performance does not necessarily reflect the actual performance of an institution.

According to a February 1994 Hong Kong Consumer Council study, Hong Kong banks' average interest rate spread — the difference between the Base Lending Rate and fixed deposit rates for maturities of between one and twelve months — was 1.65 percent above other countries with which Hong Kong was compared. Those countries included Malaysia, Singapore, the United States, and Japan. The Consumer Council found that the average monthly prime rate-savings spreads over the period 1978 to 1991 in Hong Kong were 1.79 percent higher than those in the U.K., Germany, Japan, Australia, Malaysia, and Singapore. The Monetary Authority disputes these results, arguing that its research indicates Hong Kong spreads were lower over the 1978-

1991 period and, in particular, were below the average for the countries cited over the 1988-1991 period.

Bank loans for use in Hong Kong have been expanding at an average rate of 18 percent per year over the past five years. Offshore lending to customers represented 57 percent of loans to customers and totalled HK$1,626 billion (US$208 billion) in 1993. Foreign currency lending totalled US$243 billion, or two-thirds of total loans to all customers. Continuing a three-year trend, HK$ deposits in 1993 increased at a faster rate than foreign currency deposits (25 percent vs. 5.4 percent). Total deposits were HK$1,723 billion (US$221 billion). The share of HK$ deposits in total deposits increased from 44 percent in 1991 to 46 percent in 1992 and 50 percent in 1993. This likely reflects the fact that local and foreign depositors built up HK$ deposits to take advantage of opportunities in the stock and property markets. Foreign currency interbank borrowing accounted for 77 percent of total foreign currency liabilities of HK$4,503 billion. Interbank borrowing totalled HK$3,918 billion (US$502 billion), representing 65 percent of total liabilities of the banking system in 1993.

Regulatory Framework

Hong Kong has made steady progress in strengthening its banking regulatory framework. After a series of bank failures in the early 1980s, the Hong Kong government (HKG) enacted the Banking Ordinance of 1986. It updated the previous bank legislation and gave the then-Commissioner of Banking enhanced regulatory powers, set minimum capital standards, and placed limitations on loans to individual customers, directors and employees. Since year-end 1989, Hong Kong's banking sector has been required to conform with Basle Committee standards on capital adequacy. At year-end 1993, the consolidated capital adequacy for all locally incorporated institutions was 17 percent, up from 16 percent in 1992. Supervisory responsibility for branches of foreign banks is shared with overseas banking supervisory authorities in accordance with guidelines of the Basle Committee on Banking Supervision.

Although the territory has no central bank, the Hong Kong Monetary Authority has statutory responsibility for the stability and integrity of Hong Kong's financial system and for management of reserves backing Hong Kong's currency. The Monetary Authority was created in April 1993 through the merger of the Office of the Commissioner of Banking and the Office of the Exchange Fund. The Commissioner of Banking previously exercised prudential supervision of the banking system while the Office of the Exchange Fund focussed on currency stability and managed Hong Kong's financial reserves. The de facto management board of the Monetary Authority is the Exchange Fund Advisory Committee. Members of this committee are appointed in their personal capacity. One of its members is from Citibank.

The Banking Advisory Committee (BAC) advises Hong Kong's governor on matters relating to the Banking Ordinance and banking business generally. The Advisory Committee is chaired by

the financial secretary; its members are appointed by the governor. The chief executive of Chemical Bank, a U.S. institution, is a member of the committee.

Hong Kong does not have deposit insurance. Public consultations in June 1992 revealed the lack of widespread public support for an insurance scheme. The HKG is drafting legislation that would give small depositors priority in the event of a bank liquidation.

There is growing international and local pressure for Hong Kong banks to disclose more information concerning their financial condition. A working party chaired by the Monetary Authority has recommended substantially greater disclosure of banks' profits and much more detailed balance sheet information, including transfers to/from inner reserves, on a voluntary basis, effective December 31, 1994. It recommended that the question of disclosing balance sheet inner reserves be reviewed in mid-1995. Meanwhile, banks are required to notify the Monetary Authority of transfers to and from inner reserves.

All licensed banks are required to be members of the Hong Kong Association of Banks. Two U.S. banks (Morgan Guaranty Trust and Chase Manhattan) sit on the association's main committee and, in turn, represent constituent North American banks. The association, which operates the interbank clearing system, can discipline members to the point of expulsion for breaching its rules.

Deposits of up to HK$500,000 with maturities of less than 15 months are governed by rules administered by the Association. The 30-year-old rate agreement was enacted at a time when there was concern that aggressive competition for deposits was threatening the stability of smaller local banks, which had to offer higher rates than the larger institutions. In 1994, the Hong Kong Consumer Council called for a phasing out of the interest rate rules. The council charged that the interest rate cartel has enabled banks to earn monopoly profits at the expense of small depositors. The association countered that customers would have to pay higher charges for services that are now free, that the security of the banking system could be affected from unrestrained competition, and that the proposal would undermine Hong Kong's linked exchange rate.

The Legislative Council subsequently passed a motion calling for the HKG to abolish legislation that permits the association to set maximum rates on interest. The HKG announced in late July 1994 that, based on a Monetary Authority study, there did not appear to be conclusive evidence suggesting that banks in Hong Kong are reaping excessive profits because of the interest rate rules. However, the government nonetheless accepted the Consumer Council's recommendation to deregulate time deposit interest rates in 1995. It decided that any further steps to lift the interest rate rules should be considered only after the impact of deregulation of time deposit interest rates have been fully assessed.

The Hong Kong Association of Banks subsequently announced an agreed-on timetable for deregulation of time deposits currently under the interest rate rules. Interest on deposits fixed for more than one month will be deregulated on October 1, 1994; for deposits fixed for more than seven days, January 3, 1995; and deposits fixed for more than 24 hours call on April 1, 1995. Twenty-four hour call deposits will be deregulated gradually by reducing the deposit cap from HK$500,000 to zero in stages during the remainder of 1995 subject to Hong Kong Monetary Authority and association approval.

U.S. PRESENCE IN THE MARKET

As of the end of 1993, U.S. financial institutions operated a total of 33 authorized institutions — i.e., banks, restricted license banks, or deposit taking companies — and eight local representative offices. Fourteen U.S. financial institutions operated licensed banks in Hong Kong, with a total of 71 branches. There were eight restricted license banks owned by U.S. institutions, engaged mainly in merchant banking and trade finance. Activities of 11 U.S. deposit taking companies, which together maintained a total of 26 branches, span deposit-taking, vehicle finance, trade finance, and securities and brokerage operations. Eight U.S. banks maintained local representative offices. Exhibit 3 at the end of this chapter contains a list of all authorized institutions, the number of branches each maintained, and a brief summary of activities.

U.S. institutions' share of the Hong Kong market remained stable in 1993, accounting for 5 percent of total assets, 9 percent of loans for use in Hong Kong, 7 percent of HK$ assets, and 5 percent of HK$ deposits. In contrast, Japanese institutions, while accounting for only 5 percent of HK$ deposits in 1993, held 53 percent of total assets, down from 55 percent in 1993 and 58 percent in 1991. Although Japanese institutions were the largest players in offshore lending, their market share of loans for use in Hong Kong continued to decline, from 26 percent in 1990 to 20 percent in 1993. Chinese institutions accounted for 25 percent of HK$ deposits in 1993, up from 21 percent in 1989. Chinese institutions' share of HK$ assets increased to 10 percent in 1993, but their share of loans for use in Hong Kong decreased from 17 percent to 16 percent, reversing an upward trend of the previous two years.

According to HKG records, two U.S. banks held stakes in excess of 10 percent in two local banks. BNY International Financing Corporation, a subsidiary of the Bank of New York Company, Inc., held a 35 percent stake in Wing Hang Bank. Wells Fargo Bank, N.A., held a 20 percent stake in Shanghai Commercial Bank Ltd.

The following table shows the market shares of U.S. authorized institutions as of December 31, 1993:

	Authorized Institutions (HK$ billions)				
	Total Assets	Total Loans	(of which HK$)	Total Deposits	(of which HK$)
All	6,109	2,856	957	1,722	786
U.S.	298	115	77	118	28
Percent of Total	4.9	4.0	8.0	6.9	3.6[1]
U.S. Banks	268	100	65	115	28
Percent of Total	4.4	3.5	6.8	6.7	3.6

HK$7.8=US$1

[1] Excludes swap deposits; if included, figure increases to 5 percent.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Banks incorporated outside Hong Kong that wish to establish a licensed bank branch in the territory generally must satisfy four criteria: (1) have assets of US$16 billion (net of contra items); (2) be incorporated in countries in which the home supervisor can meet the minimum standards of supervision of international banks recommended by the Basle Committee on Banking Supervision; (3) have the consent of their home authorities for establishment of a branch in Hong Kong; and (4) the bank's country of incorporation must provide an acceptable form of reciprocity to Hong Kong banks. In exceptional cases, licenses may be granted even though the US$16 billion requirement is not met where: i) the applicant is of undoubted standing; and ii) taking account of the representation in Hong Kong by banks from the applicant bank's country, granting a license to the applicant would serve Hong Kong's interests as a broad-based international financial center. Licenses are granted in accordance with the Banking Ordinance at the discretion of the Governor in Council, i.e., Hong Kong's Executive Council. Foreign banks are expected first to establish a representative office prior to upgrading to a licensed branch.

Foreign banks cannot establish as wholly-owned subsidiaries, due to the licensing criteria that the applicant should be predominantly beneficially owned by Hong Kong interests. However, foreign banks may acquire an interest, including a controlling interest, in a local bank, which has unlimited branching rights.

Overseas banks granted licenses after 1978 may maintain offices to which customers have access in only one building. The word "office" includes any automated teller machine or similar terminal device that provides facilities to the customers of the bank. This restriction took effect when the HKG lifted a moratorium on new banking licenses that had been in place since 1965. The HKG argued that it was concerned about overcrowding in the retail banking market and that

unrestrained entry might undermine the stability of the banking system. On September 30, 1994, this rule was modified to permit foreign banks to establish a regional office and one back office in a building or buildings separate from its branch office in Hong Kong. Foreign banks cannot establish as wholly-owned subsidiaries, due to the licensing criteria that the applicant should be predominantly beneficially owned by Hong Kong interests. Foreign banks can acquire partial or sole ownership of local banks and in this way expand their branch networks. Approval is required to acquire a 10 percent or greater interest in the voting share capital of a local bank.

U.S. financial institutions raised no substantive issues regarding national treatment. There are no limitations on foreign equity ownership of local banks (other than the approval noted above), no restrictions on the introduction of technology (excepting the ATM limitation for post-1978 banks noted earlier), nor any restrictions on lending Hong Kong dollars offshore. U.S. and other foreign banks have full access to domestic currency retail deposits and have a voice in the policies that affect their industry.

Except for the limitation on the number of offices foreign banks licensed after 1978 may establish, Hong Kong imposes no other barriers to U.S. or other foreign financial institutions. U.S. banks that have established branches since 1978 have tended to concentrate in wholesale banking, money market operations, trade finance, and the securities business. No U.S. institution established since 1978 in Hong Kong that responded to the National Treatment Study survey expressed concern over their inability to branch because of that policy.

U.S. institutions generally give authorities high marks for fairness and transparency and generally expressed the view that Hong Kong does not discriminate in terms of competitive opportunities. Activities are conducted on an equal legal and regulatory footing with both local and foreign institutions. Some cited Hong Kong's fierce competitive environment as a "drawback," yet the territory is regarded as "wide open and unobstructed" in allowing institutions scope to choose vehicles in which to conduct business.

Exhibit 1 — Balance Sheet of All Authorized Institutions
(HK$ billions)

	1993		
Assets	**HK$**	**Foreign Currency**	**Total**
Loans to Customers	957	1,900	2,857
Inside HK	934	244	1,178
Outside HK	16	1,611	1,626
Others	7	45	52
Interbank Lending	407	2,252	2,659
Inside HK	313	249	562
Outside HK	94	2,003	2,097
Negotiable CDs	16	19	35
Bank Acceptances and Bills of Exchange	3	48	51
FRN & Commc. Paper	5	81	86
Securities & Investments	110	139	249
Other Assets	49	75	125
Total Assets	**1,547**	**4,515**	**6,602**
Liabilities			
Deposits from Customers	858	864	1,723
Interbank Borrowing	441	3,477	3,918
Inside HK	311	247	559
Outside HK	130	3,229	3,359
Negotiable CDs	33	21	55
Other Liabilities	226	141	367
Total Liabilities	**1,558**	**4,503**	**6,063**

Source: HKMA Annual Report 1993

Exhibit 2 — Loans and Deposits in 1993 by Category of Authorized Institution (HK$ billions)

Loans and Advance	HK$	Foreign Currency	Total
Licensed Banks	859	1,854	2,714
Restricted License Banks	57	23	79
Deposit-Taking Companies	42	22	64
Total	**958**	**1,899**	**2,857**
Deposits from Customers			
Licensed Banks	843	833	1,676
Restricted License Banks	6	23	29
Deposit Taking Companies	9	8	17
Total	**858**	**864**	**1,722**

Source: HKMA Annual Report 1993

Exhibit 3 — U.S. Authorized Institutions and Local Representative Offices in Hong Kong

Licensed Banks

Name/Year Licensed	No. of Branches	Major Activities
Citibank N.A. (1965)	25	Wholesale/Retail/Private Banking, Money Market Operations
Chase Manhattan Bank (1965)	9	Consumer Banking/Mortgage Corporate Finance/Private Banking
Chemical Bank (1978)	1	Shipping Loans and Trade Finance Syndication, Corporate Finance/Investment Banking
Bank of America & SA (1965)	2	Wholesale/Retail Banking, NT Loan Syndication, Commercial Lending
Bank of America (Asia) Ltd. (1965)	18	Retail Banking, Property & Consumer Lending, Trade Finance
American Express Bank Ltd. (1965)	6	Private Banking, Corporate Finance
Morgan Guaranty Trust Co. of NY (1978)	1	Corporate Finance, Capital Markets, Debt/Equity Finance, Direct Investment, Project Finance, Underwriting, Private Banking
First National Bank of Chicago (1979)	1	Treasury Operations, Capital Markets and Derivatives
Bankers Trust Co. (1981)	1	Corporate Finance, Capital Markets
Republic National Bank of NY (1979)	1	Banknotes Trading, Treasury Operations, and Private Banking
State Street Bank & Trust Co. (1994)	1	Trade Finance and Custodian Services
The Bank of NY (1983)	1	Trade Finance
First National Bank of Boston (1978)	1	Trade Finance
Norwest Bank Minnesota (1989)	1	Trade Finance

Restricted License Banks

Name/Year Licensed	No. of Branches	Major Activities
Citicorp International Ltd. (1978)	1	Merchant Banking
Chase Manhattan Asia Ltd. (1984)	1	Merchant Banking
Manhattan Card Co. Ltd. (1993)	1	Credit Card Business
BA Asia Ltd. (1982)	1	Merchant Banking and Underwriting of Capital Market Instruments
Lehman Brothrs Finance Ltd. (1983)	1	Share Margin Financing
Corestates Bank, N.A. (1990)	1	Trade Finance
Pacific Bank N.A. (1990)	1	Trade Finance
NBD Bank N.A. (1991)	1	Trade Finance and Advisory Services
Deposit Taking Companies		
Citicorp Commercial Finance (HK) Ltd. (1981)	1	Vehicle Finance, Leasing and Machinery Finance
Chemical Securities Asia Ltd. (1976)	1	Capital Market Activities and Securities Trading
BA Finance (HK) Ltd. (1976)	1	Deposit Taking
Canton Pacific Finance L:td. (1976)	1	Deposit-Taking and Property Loan
Inchroy Credit Corporation Ltd. (1976)	4	Auto Financing
Security Pacific Credit (HK) Ltd. (1976)	12	Auto and Equipment Financing and Property Lending
First Chicago Hong Kong Ltd. (1976)	1	Holding Company of First Chicago Capital Markets Asia Ltd.
First Chicago Capital Markets Asia Ltd. (1989)	2	Debt and Equity Securities Trading

BT Asia Ltd. (1987)	1	Securities Trading and Financial Advisory Services
BT Asia Securities Ltd. (1976)	1	Securities Brokerage
Hawaii Financial Corp. (HK) Ltd. (1978)		Trade Finance

Local Representative Offices

Name/Year Licensed	No. of Branches	Major Activities
Bank of Hawaii (1977)	1	Liaison
Bank of New York - Inter-Maritime Bank Geneva (1993)	1	Research and Liaison
Cathay Bank (1984)	1	Research and Liaison
Republic National Bank of NY (Suisse) S.A. (1992)	1	Research and Liaison
Republic National Bank of NY (Luxembourg) (1992)	1	Research and Liaison
Wells Fargo Bank N.A. (1989)	1	Research and Liaison
Offitbank (1994)	1	Research and Liaison
Fiduciary Trust Co. International (1989)	1	Research and Liaison

Source:Hong Kong Government Financial Services Branch, Authorized Institutions.

Note: Business activities of several listed U.S. institutions pre-date granting of license, e.g., Citibank established in Hong Kong in 1902, Chase Manhattan in 1930.

Exhibit 4 — Market Share of Total Assets for Institutions by Origin of Ownership (percent)

Region	1989	1990	1991	1992	1993
China	8	8	8	9	10
Europe	13	12	11	12	12
Japan	56	58	58	55	53
USA	6	6	5	5	5
Other[1]	17	16	18	19	20
Total	100	100	100	100	100

[1]Includes Institutions in HSBC Holdings Group

Source: Hong Kong Monetary Authority Annual Report 1993

Exhibit 5 — Market Share of Loans for Use in Hong Kong by Origin of Ownership (percent)

Region	1989	1990	1991	1992	1993
China	14	13	15	17	16
Europe	18	17	16	16	16
Japan	25	26	24	21	20
USA	9	10	9	9	9
Other[1]	34	34	36	37	39
Total	**100**	**100**	**100**	**100**	**100**

[1]Includes trade finance loans but excludes loans to finance trade not touching Hong Kong.

Source:Hong Kong Monetary Authority Annual Report 1993

Exhibit 6 — Market Share of HK Dollar Deposits by Origin of Ownership (percent)[1]

Region	1989	1990	1991	1992	1993
China	21	22	23	25	25
Europe	13	12	11	11	11
Japan	4	5	4	4	5
USA	6	6	5	6	5
Other	56	55	56	54	54
Total	**100**	**100**	**100**	100	100

[1]Adjusted to include swap deposits.

Source: Hong Kong Monetary Authority Annual Report 1993.

HONG KONG

SECURITIES

SUMMARY

Hong Kong is the world's fifth-largest merchandise exporter and also the fifth-largest trading territory. It is the principal conduit for capital and trade flows to and from China. Services account for 76 percent of GDP, which reached US$18,500 per capita in 1993. The territory accounts for more than two-thirds of foreign direct investment in China. Laissez faire economic policies, complete freedom of capital movement, low taxes, modern infrastructure, and a well-understood regulatory and legal environment have greatly facilitated Hong Kong's growing role as a trade entrepôt and international financial center. Eighty-one of the world's top 100 banks operate in the territory. The Sino-British Joint Declaration and Basic Law provide the legal basis for maintaining Hong Kong's capitalist system when China regains sovereignty over the territory from Britain on July 1, 1997.

The Stock Exchange of Hong Kong (SEHK) ranked sixth-largest in market capitalization in 1993, up from 15th-largest in 1990. The exchange is playing a significant and growing role in raising equity capital for PRC state-owned enterprises. From 1990 through 1993, market capitalization increased 3.5 times, while the number of listed firms grew from 299 to 477. U.S. firms hold 7 of the 80 foreign corporate memberships on the SEHK, out of a total exchange membership of 570 (249 corporate, 321 individual).

The Hong Kong Futures Exchange offers stock exchange index and sub-index futures, index options, and three-month Hong Kong Interbank Offered Rate (HIBOR) futures. As of March 31, 1994, 36 percent of HKFE members were foreign companies; five were controlled by U.S. companies. Although fiscal surpluses have obviated the need to borrow to finance government expenditures, the Hong Kong Government has taken a number of steps to develop a debt market. These include a bills and notes program with maturities currently out to five years, tax exempt status for multilateral debt issues, and the establishment of a Central Moneymarkets Unit as a central depository for debt instruments.

Operation and regulation of Hong Kong's stock and futures markets has strengthened considerably in line with wide-ranging recommendations made by a Securities Review Committee appointed in the wake of the 1987 market crash. The Securities and Futures Commission (SFC) has supervisory powers to ensure the integrity of markets and protection of investors. Securities and futures intermediaries must be registered with the Securities and Futures Commission (SFC). Besides capital and liquidity requirements, intermediaries must satisfy nondiscriminatory "fit and proper person" criteria before they can conduct business. They may be established as either branches or as subsidiaries, although in practice most firms form subsidiaries. The rules are the same irrespective of ownership — foreign or domestic. Subject to licensing and registration requirements, foreign and local institutions can engage in a full range of investment banking and brokerage activities.

U.S. financial institutions have a substantial and rapidly expanding presence in Hong Kong. As of end-March, 1993, there were 22 U.S.-controlled securities dealers out of 178 foreign securities dealers. There were 11 commodities dealers controlled by U.S. companies out of a total of 52 foreign-owned commodities dealers. Of 33 bank and nonbank U.S. financial institutions contacted regarding their Hong Kong operations, none that responded expressed any substantive concerns about national treatment. Respondents generally viewed Hong Kong as the most open environment in Asia within which to do business. The regulatory environment was generally viewed as fair, supportive, flexible, and transparent.

DESCRIPTION OF THE MARKET

Since the stock market crash of October 1987, Hong Kong has made a sustained effort to redevelop its financial markets and regulatory framework to bring them up to international standards. Financial markets in the territory have experienced robust growth during the 1990s. Sustained regional prosperity, the attendant accumulation of wealth, and vast capital needs for infrastructure development — particularly in China — are among the factors that have contributed to their development. Hong Kong's vibrant, open economy, laissez faire approach to economic policy, absence of foreign exchange controls, low and predictable taxation, modern telecommunications and physical infrastructure, and a transparent, well-understood legal and regulatory environment underpin the territory's role as a regional and international financial center. Hong Kong's time zone enables foreign market participants to bridge the gap between New York and London. There is only one restriction on foreign shareholding, relating to the television broadcasting sector.

The Sino-British Joint Declaration, signed in 1984, and the Basic Law, promulgated by China in 1990, form the legal basis for China's "One Country, Two Systems" guarantees for Hong Kong when it becomes a Special Administrative Region of China (HKSAR) in 1997. The Basic Law guarantees the rights and freedoms Hong Kong residents now enjoy, the continued rule of law, and the maintenance of Hong Kong's capitalist system for 50 years. Defense and foreign affairs of the HKSAR will be under the direct control of Beijing. The HKSAR will retain the status of an international financial center and safeguard the free flow of capital. It will, on its own, formulate monetary and financial policies, and safeguard the free operation of business and financial markets. The HKSAR will have independent finances, using revenues exclusively for its own purposes. The Hong Kong dollar will continue to circulate as the legal tender of the HKSAR and be freely convertible. Markets for foreign exchange, gold, securities, and futures shall continue to operate. Systems currently in place, including Hong Kong's regulatory and supervisory framework, will remain unchanged.

The Stock Exchange of Hong Kong Ltd.

The territory's first formal stock market was established in 1891. The SEHK was formed in 1986 through the unification of the four exchanges in existence at the time. The Hong Kong Exchange was ranked sixth-largest in the world in terms of market capitalization at the end of 1993, up from 15th-largest in 1990. In addition to ordinary and preference shares, warrants, unit trusts and debt securities also are listed on the SEHK. In 1993, 68 new listings raised US$3.7 billion, up from 17 new listings that raised US$403 million in 1990. The number of listed companies increased from 299 in 1990 to 477 in 1993. Market capitalization grew from US$83.4 billion to US$381.5 billion during the same period, while average daily turnover increased from US$149 million to US$630 million. (Exhibit 1 at the end of this chapter contains five-year data on new listings. Exhibit 2 contains selected performance data. Exhibit 3 provides a breakdown of market capitalization by sector.) As of March 1994, 57 companies listed in Hong Kong had a listed/trading status in the U.S. through the NYSE, NASDAQ, or PORTAL.

In 1993, the SEHK was among the world's best-performing bourses. The Hang Seng Index of blue chip stocks, which consists of 33 of Hong Kong's largest, most liquid equities, closed a record 116 percent higher than year-end 1992. Market valuation levels demonstrated almost no sensitivity to increased Sino-British tensions over proposed electoral reforms in Hong Kong, reflecting a lowering of the risk premium associated with political uncertainty. Investors sought to "buy in" to China's dynamic growth either through purchasing shares of firms that conduct substantial business with China, or shares of PRC firms listed on the SEHK, either directly or through shell companies. Negative real interest rates in Hong Kong also played a role in driving equity prices upward. (The market has since dropped some 19 percent as of October 31, 1994, from its 1993 close.)

The SEHK is playing an increasingly important role in raising equity capital for PRC state enterprises. A memorandum of understanding on regulatory cooperation between the PRC and Hong Kong stock market authorities signed in June 1993 provides a framework for Chinese state enterprises to raise equity in Hong Kong through the issuance of "H" Shares, provided they meet Hong Kong regulatory and accounting requirements. "H" shares are denominated in renminbi, but must be purchased in Hong Kong dollars. The MOU also provides for cooperation in enforcement of laws and regulations in the areas of market manipulation, insider dealing, and other fraudulent practices. Through March 31, 1994, seven of the first group of nine PRC state-owned companies approved to list outside of China had listed on the SEHK. In early 1994, Beijing approved a second batch of 22 PRC state-owned enterprises to list overseas. Most of these are expected to apply for primary listing status on the SEHK.

As of February 28, 1994, the market capitalization of the six listed "H" shares totalled about HKD14.8 billion, representing 0.56 percent of the total market capitalization of HKD2,642 billion. (Exhibit 4 details "H" shares listed as of February 28, 1994.) As of the end of 1993,

"Red Chips" — firms on the SEHK in which PRC interests held at least 30 percent ownership — were estimated to account for between 6 and 7 percent of SEHK market capitalization.

As of March 31, 1994, the SEHK had 570 members, including 321 individual and 249 corporate members. Each member must hold at least one share in the SEHK, which entitles the holder to a seat on the exchange floor. There are 1,200 authorized shares. There are no specific restrictions on expatriates becoming individual members. All applicants for membership are subject to uniform requirements including being of good character and having experience in dealing in securities and meeting capital adequacy requirements. An individual member is required to have been ordinarily resident in Hong Kong for five out of seven years immediately preceding his/her application. A corporation must be incorporated in Hong Kong, be of good financial standing, and be registered by the Securities and Futures Commission.

As of March 31, 1994, 80 corporate members, representing 14 percent of the SEHK's total membership, were controlled by foreign companies. Seven were controlled by U.S. companies. Out of 336 registered commodities dealers, 15 percent, or 52 were controlled by foreign companies, including 11 controlled by U.S. companies. Of 1,438 registered securities dealers at March 31, 1994, 12 percent, or 178 were controlled by foreign companies, including 22 controlled by U.S. companies.

As of March 31, 1994, there were 11,309 registered businesses in Hong Kong involved in securities and commodities dealing and advising. The number of securities firms from the People's Republic of China went from zero in 1993 to eight as of March 31, 1994. There were 38 from Japan, 11 from Singapore, 7 from Taiwan, 6 from Australia, 4 each from Thailand and Indonesia, and one each from Korea and Malaysia.

Any firm in Hong Kong involved in dealing in securities, trading commodity futures contracts, or giving advice on investments in securities or commodity futures must be registered with the Securities and Futures Commission. Among the laws with which they must comply are the Securities Ordinance, the Commodities Trading Ordinance, and the Securities and Futures Commission Ordinance. Besides net capital and liquidity margin requirements, the SFC requires that applicants satisfy "fit and proper person" criteria. These relate generally to ensuring that the applicant is fair, honest, and financially sound.

Authorized institutions as defined under Hong Kong's Banking Ordinance are increasingly diversifying away from deposit-taking activities into financial areas including the securities business. Licensed banks, restricted license banks, and deposit taking companies accounted for almost 70 percent of the 229 "exempt" dealers and investment advisers registered in Hong Kong as of March 31, 1994. Generally, a firm can be declared an exempt dealer for the purpose of the Securities Ordinance if its main business is not in securities dealing, or if its main business is securities dealing only at the wholesale level, with any securities dealing at the retail level done through a registered member of the SEHK or through other authorized channels. Licensed

banks and trustee companies may also be eligible for exempt dealer status even if they do not satisfy these criteria. A firm can be declared an exempt investment adviser if it gives investment advice only to people residing outside of Hong Kong.

Reforms Since 1987

The recommendations of a Securities Review Committee (SRC) appointed in the wake of the October 1987 stock market crash resulted in a fundamental revamping and professionalizing of the Hong Kong securities industry. The crash led the SEHK and the Hong Kong Futures Exchange to suspend trading for four days. The Hong Kong Government led a group of lenders in arranging a HKD2 billion rescue package to support the Hong Kong Futures Guarantee Corporation to meet futures contracts of defaulting members.

The SRC found that Hong Kong's system of self-regulation and self-discipline had failed to develop adequately to cope with the expanding securities industry. It found that an inside group had treated the exchange as a "private club" rather than a pubic utility for the general benefit of members. The committee called for re-establishing the market based on international standards of regulation and surveillance with the goal of Hong Kong becoming the primary capital market for Southeast Asia.

Most of the SRC's major recommendations have since been implemented. The constitution of the SEHK was revised to broaden representation on the governing Exchange Council to include individual, corporate and independent members. Stock exchange staff were professionalized. The settlement period was extended from 24 to 48 hours and a central clearing system was established. The clearing and guarantee system for the Hong Kong Futures Market was restructured and a HKD200 million reserve fund was established.

Regulation and Oversight

A number of ordinances govern securities dealings in Hong Kong. The Securities Ordinance, the Stock Exchanges Unification Ordinance, and the Securities and Futures Commission Ordinance require registration of dealers, dealing partnerships, investment advisers and other intermediaries. They provide for investigation of malpractice and a compensation fund for clients of defaulting brokers. The Securities (Insider Dealing) Ordinance of 1991 significantly increased penalties for insider dealing. The Securities (Disclosure of Interests) Ordinance of 1991 requires company shareholders with 10 percent or greater voting shares to publicly disclose their interests and for directors and executives to disclose dealings. The Protection of Investors Ordinance imposes penalties for fraudulent or reckless misrepresentation. The Companies Ordinance relates to all companies, including firms and organizations in the securities industry incorporated as companies and includes requirements relating to the marketing of securities. The Commodities Trading Ordinance and the Securities and Futures Commission Ordinance provide the regulatory framework for operation of the Hong Kong Futures Exchange. They require

registration of dealers and their representatives and maintenance of a compensation fund for clients of defaulting commodity dealers.

The Securities and Futures Commission

Established in 1989, the SFC is an independent statutory body outside the civil service with licensing and supervisory powers to ensure the integrity of markets and protection of investors. The SFC assumed the functions of the former Securities Commission, the Commodities Trading Commission, and the Office of the Commissioner for Securities and Commodities Trading. The SFC has worked since its inception to build a regulatory framework consistent with international standards, to encourage greater efficiency and transparency in trading systems, and to strengthen supervision and enforcement.

Recent Developments

The SFC has recently focused on improving minority shareholder protection and enhancing corporate governance. It is working to update and rationalize Hong Kong's securities and futures legislation. Codes of conduct for the SEHK and Futures Exchange were finalized in 1993 and the SFC introduced a code of conduct applying to all other persons registered under the Securities Ordinance and Commodities Trading Ordinance in 1994. The SFC also has regulatory powers over certain aspects of the foreign exchange market under the Leveraged Foreign Exchange Trading Ordinance that Hong Kong's Legislative Council (LEGCO) has recently enacted. The ordinance is designed to regulate so-called "fringe forex dealers" who are not currently regulated and who provide leveraged foreign exchange contracts to retail investors. Funding for SFC operations comes primarily from the market transaction levies and SFC fees and charges.

The SEHK introduced regulated short selling of 21 blue chip stocks in January 1994. Short selling has been conducted on a very limited basis because of a 14-day return requirement for borrowed stock in order to receive a "stamp duty" exemption. The stamp duty is equal to 0.30 percent of the value of the borrowed stock (0.15 percent per side on each side of the transaction). Short selling is expected to increase as a result of recent legislation that extends the borrowing period to 12 months. Planning is underway to introduce stock options trading.

The SEHK introduced a computerized Automatic Order Matching and Execution System (AMS) in late 1993. AMS provides real-time order entry and execution and near-instantaneous reporting of transactions. Trades are executed automatically when buy and sell prices match. Settlement of securities among brokers is handled by electronic book entry through a Central Clearing and Settlement System (CCASS) introduced in 1992. Traders computer-input trades from their booths on the floor of the SEHK. Exchange trading hours are from 10:00 p.m. to 12:30 p.m. and from 2:30 p.m. to 3:45 p.m.

The Securities and Futures Commission (SFC) released in July a consultation paper inviting public comment on proposals to ban or regulate cash commission rebates and "soft dollar" benefits received by portfolio managers from brokers in exchange for brokerage business placed with them by investment managers. In relation to unit trusts and mutual funds, the SFC proposes to prohibit the retention of cash commission rebates by portfolio managers and would regulate soft dollar practices. In relation to private discretionary accounts (e.g., pension funds), the SFC proposals would initially be based on a disclosure regime. In the long run, however, the SFC intends to prohibit cash rebates for discretionary accounts. Soft dollar standards would be regulated.

The SFC released in August 1994 a consultation paper inviting public comments on the recent IOSCO (International Organization of Securities Regulations) Guidelines on Operational and Risk Management controls for OTC derivatives. The SFC paper proposes to recommend the adoption of IOSCO guidelines as best practice for the Hong Kong financial community and to take compliance with such guidelines into account in deciding on the "fit and proper" status of regulated entities. The paper also discusses various possible approaches to the regulation of risk management of derivatives.

Futures

The Hong Kong Futures Exchange, known before 1986 as the Hong Kong Commodity Exchange, began offering futures in sugar, cotton, soybeans, and gold in 1977. Commodities trading in Hong Kong began formally in 1910, however, when the Chinese Gold and Silver Exchange Society was established. The first financial futures contract was the Hang Seng Index Future. Trading began in 1986 and by 1987 average daily volume grew to 25,000 contracts per day. The HKFE undertook significant reforms and restructuring after the October 1987 crash, but trading volumes did not significantly recover until 1993. (See exhibit 5). Futures based on the four Hang Seng subindices — finance, properties, utilities, and commerce and industry — were launched in 1991. The HKFE also offers three-month Hong Kong Interbank Offered Rate (HIBOR) futures and launched HSI options in March 1993. In October 1994, the HKFE announced its intention to begin trading by the end of the year two new stock futures contracts — HSBC Holding plc and Hong Kong Telecommunications Ltd.

Trading on the HKFE is on an open outcry basis. A clearing system installed under agreement with the Options Clearing Corporation of Chicago provides state-of-the-art clearing and risk management capabilities. There were 110 members of the HKFE as of March 1994. Of that number, 108 were corporations and two were individuals. Forty corporations, or 36 percent of HKFE members, were controlled by foreign companies. Corporate members controlled by U.S. companies included: Hull Trading Asia Ltd., Merrill Lynch Futures (HK) Ltd., Morgan Stanley Futures (HK) Ltd., Paine Webber International Futures (Asia) Ltd. and Salomon Brothers HK Futures Ltd.

The Debt Market

The public and private debt markets in Hong Kong have developed much more slowly than the equity and commodity markets. Repeated budget surpluses have meant the Hong Kong Government has not had to borrow to finance debt. Few Hong Kong companies had the need, or the credit rating, to raise funds via debt offerings. Debt instruments consisted primarily of bank certificates of deposit and commercial paper. However, initiatives by the Hong Kong government to develop a benchmark yield curve for local debt, the granting of tax exempt status for multilateral issuers, the issuing by offshore entities of locally denominated debt, growing corporate demand for medium- and long-term financing, and increased demand from pension funds and other investors for quality fixed-rate instruments have spurred development of this market in Hong Kong.

In March 1990, the Hong Kong government launched an Exchange Fund Bills program with the issuance of 91-day bills. This was primarily to facilitate money market intervention to maintain stability of Hong Kong's linked exchange rate with the U.S. dollar. A bond program was launched in November 1992, but it will be phased out by early 1995 and replaced with two-year Exchange Fund Notes, which are issued in minimum denominations of HKD50,000. The Hong Kong Monetary Authority (HKMA) runs the Exchange Fund bills and notes programs and, in October 1993, issued Exchange Fund debt with a maturity of three years, extended to five years in September 1994. In September 1994, the HKMA launched the first issue of five-year notes. Exchange Fund bills are issued in paperless form in minimum denominations of HKD500,000 on a discount basis. Some 28 recognized dealers are appointed as market makers who are obliged to quote two-way yields for the bills. The following table gives an indication of the size of the government program:

Issues of Exchange Fund Bills, Government Bonds, and Exchange Fund Notes (HKD millions)

Year	New Issues	Amount Outstanding	Average Daily Turnover
1990	16,266	7,540	1,459
1991	30,700	14,640	4,963
1992	43,900	23,340	7,946
1993	66,940	31,660	15,276

Source: Hong Kong Government, Financial Services Branch

Daily turnover of bills, notes, and two-year bonds in the secondary market averaged HKD15.3 billion, or 48 percent of the total amount of bills, notes, and bonds outstanding at year-end 1993 of US$31.7 billion.

The following table provides an indication of the amount of major debt instruments outstanding. All figures are in HKD millions, including bonds issued in other foreign currencies.

Major Debt Instruments Outstanding (HKD millions)

Year	Exchange Fund Bills and Notes	Government Bonds	Corporate Bonds	Multilaterals	Negotiable Certificates of Deposit
1989	--	--	4,010	500	33,897
1990	7,540	--	3,698	1,600	36,228
1991	14,040	600	3,281	4,440	31,323
1992	20,340	3,000	2,779	7,780	34,323
1993	26,260	5,400	N.A.	20,643	54,716

Note: "Corporate Bonds" refers only to those bonds listed on the SEHK. They do not cover private placements, which are substantial. Figures include bonds issued by local and foreign corporations.
Source: Hong Kong Government, Financial Services Branch

It is estimated that roughly one-half of the HKD2.8 billion in corporate bonds outstanding at the end of 1992 was issued by local corporations. GE Capital Corporation has tapped the Hong Kong dollar market for a total of four issues through the end of 1993. Outside of Japan, Hong Kong is reportedly the only location in Asia that allows offshore issuance in its domestic currency, without requiring proceeds to be used in the territory of the domestic currency.

The IBRD was the first multilateral institution to launch a HKD-denominated bond issue in 1989. In 1991, the ADB was the first multilateral to issue non-HKD Dragon Bonds in Hong Kong. HKD-denominated debt of the following multilateral institutions is exempt from profit tax and stamp duties: Asian Development Bank, International Bank for Reconstruction and Development, International Finance Corporation, European Investment Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, and Nordic Investment Bank.

An indication of trends in fixed-rate Hong Kong Dollar Debt can be seen in the following chart:

Fixed-Rate Hong Kong Dollar Debt			
	1991	1992	1993
Number of Issues	96	93	95
Volume (HKD billions)	9.25	9.9	16.5
Commercial Bank Issues as a Percentage of All New Paper	77	52	44
Japanese Banks' Percent of Bank Issues	49	24	13
Percentage of New Paper with Maturity Over Five Years	6	15	44

Source: Oakreed Financial Services, Ltd.

In January 1993, the Hong Kong Monetary Authority established a Central Moneymarkets Unit (CMU) service to provide a computerized book-entry system for Hong Kong dollar money market and capital market bearer instruments. The CMU service provides a central depository for CMU instruments and an electronic book-entry system which eliminates the need for physical delivery of the instruments between CMU members. The HKMA has also established a working group on mortgage securitization aimed at enhancing credit standards of these instruments similar to the conforming loan standard of the U.S. Federal National Mortgage Association.

Funds Management

Securities firms, provided they obtain an investment advisor license, and foreign banks are allowed to engage in fund management activities and can manage local pension fund monies or other institutional monies. Under the Securities Ordinance, authorized institutions under the Banking Ordinance are excluded from the scope of investment adviser regulations. According to the HKG Financial Services Branch, authorized institutions in Hong Kong can engage in portfolio management without the need to obtain an investment advisor license. Foreign securities firms and banks can sell foreign mutual funds to local investors provided they obtain a dealer license (or obtain exempt dealer status) under the Securities Ordinance, and meet domestic mutual fund requirements.

Cross Border

Residents may freely access financial instruments offshore. There are no capital controls limiting either the amount or kinds of products that residents may invest in. Residents also can

freely access offshore markets as issuers of securities or notes, and U.S. firms have participated in underwriting these issues.

U.S. PRESENCE IN THE MARKET

U.S. financial institutions have a substantial, broad-based, and growing presence in Hong Kong's securities markets. Several bank and nonbank institutions have been active for decades; others have entered the market in recent years.

A number of U.S. banks, through affiliates or subsidiaries, as well as nonbank financial institutions, are involved in a broad range of investment banking and other capital market activities. These include, but are not limited to, foreign exchange trading, funds management, debt and equity underwriting, mergers and acquisitions, derivatives sales and trading, brokerage and dealing domestic and foreign securities, commodities dealing, project finance, custody and other fiduciary services. In some cases, they act as advisers to the Hong Kong government on infrastructure projects.

Among U.S.-based institutions that maintain a significant presence in Hong Kong are Bear Stearns, CS First Boston, Goldman Sachs, J.P. Morgan, Lehman Brothers, Morgan Stanley, Merrill Lynch, and Salomon Brothers. Others include Smith Barney, Prudential Securities, Kidder Peabody, Fidelity Investments Management, and American International Assurance through AIGIC. Several U.S. banks — directly or through subsidiaries and affiliates — are active in securities and capital markets services. These include Bankers Trust, Citibank N.A., Chase Manhattan Bank, Chemical Bank, Bank of America, First National Bank of Chicago, and Republic National Bank of N.Y. Mellon Asia is active in trust and investment management. No attempt is made to classify individual U.S. financial institutions by major area of activity because of the lack of a complete data base on individual institutional activities.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no legal constraints per se to foreign securities firms establishing in Hong Kong via branching, acquisition or subsidiary. Under the Securities Ordinance, applicants are required to meet "fit and proper person" criteria, net capital and liquidity margin requirements. In practice, foreign securities firms typically establish via subsidiaries, which can be wholly or partially owned. The rules are the same irrespective of ownership — domestic or foreign.

Of 33 bank and nonbank U.S. financial institutions contacted in Hong Kong regarding this study, none who responded expressed any substantive concerns regarding denial of national treatment. There are no impediments to the free flow of financial resources. Foreign entities can issue securities in Hong Kong subject to protection of investor legislation and listing requirements. There are no restrictions on sales and marketing of Hong Kong issues outside of the territory. There are no restrictions on trading Hong Kong debt and equity instruments offshore.

Respondents generally view Hong Kong as the most open environment in Asia within which to do business. While most of Hong Kong's history has seen a laissez faire approach to securities markets, two respondents noted that there has been a decided trend toward greater supervision and regulation. One firm indicated it would like to see tightened rules and regulations to limit or eliminate questionable practices such as brokerage rebates.

The legal system in Hong Kong makes no distinction between local and foreign corporations. Licensing is viewed as fair, with no significant distinctions made between local and overseas incorporated applicants. Regulations are published in English. Institutions have access to regulatory authorities and are often consulted; for example, the Hong Kong Capital Markets Association meets regularly with the Hong Kong government. Overall, the regulatory environment in Hong Kong is viewed as fair, supportive, flexible, and transparent.

Exhibit 1 — SEHK New Listings and Total Funds Raised 1988-1993

	1988	1989
New Listings		
— Number	40	12
— Amount of Funds Raised (HKD/mil.)	1,301	1,730
Total Funds Raised [1] (HKD/mil.)	19,715	22,035
Total Funds Raised Through Means Other Than New Listings (HKD/mil.)	18,414	20,305

	1990	1991
New Listings		
— Number	17	60
— Amount of Funds Raised (HKD/mil.)	3,146	7,171
Total Funds Raised [1] (HKD/mil.)	24,472	45,173
Total Funds Raised Through Means Other Than New Listings (HKD/mil.)	21,326	36,002

	1992	1993
New Listings		
— Number	64	68
— Amount of Funds Raised (HKD/mil.)	11,982	28,884
Total Funds Raised [1] (HKD/Mil.)	117,322	277,478
Total Funds Raised Through Means Other Than New Listings (HKD/Mil.)	105,340	248,594

[1] Includes offer for subscription, offer for sale, placing, rights issue, open offer, consideration issue, warrants exercised, investment companies, debt securites, derivative warrants, and others.

Sources: SEHK fact books 1988-1992, SFC internal data for 1993 figures.

Exhibit 2 — Stock Exchange of Hong Kong: Selected Indicators

	1988	1989
Stock Exchange of Hong Kong Ltd.		
(A) Number of Listed Companies	304	298
Number of Listed Securities	479	479
Total Market Capitalization (USD million)	74,407	77,565
Worldwide Ranking of HK Stock Market	15	16
(B) Total Market Turnover (USD million)	25,575	38,352
Average Daily Turnover (USD million)	103.1	155.9

	1990	1991
(A) Number of Listed Companies	299	357
Number of Listed Securities	520	597
Total Market Capitalization (USD million)	83,386	121,689
Worldwide Ranking of HK Stock Market	16	14
(B) Total Market Turnover (USD million)	37,015	42,834
Average Daily Turnover (USD million)	149.3	172.7

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	1992	1993
(A) Number of Listed Companies	413	477
Number of Listed Securities	749	891
Total Market Capitalization (USD million)	170,793	381,459
Worldwide Ranking of HK Stock Market	8	6
Total Market Turnover (USD million)	89,818	156,753
Average Daily Turnover (USD million)	359.3	629.5

Note: Worldwide ranking of HK stock market is based on F.I.B.V. statistics.
Sources: Stock Exchange of Hong Kong Ltd. and Hong Kong Futures Exchange Ltd.
HKD 7.80 = USD1

Exhibit 3 — SEHK Market Capitalization by Sector as of April 30, 1994

Sector	Percent
Properties	27.4
Conglomerates	28.4
Finance	19.2
Utilities	15.0
Industrials	6.8
Hotels	2.9
Others	0.3
Total	100.0

Source: The Securities Journal, April 1994

Exhibit 4 — Shares Listed in Hong Kong as of February 28, 1994

	No. of H Shares	Share Price 2/28/94 HKD/share
Shanghai Petrochem	1,680,000,000	2.625
Tsingtao Brewery	346,850,000	8.25
Guangzhou Shipyard	157,398,000	4.100
Beiren Printing	100,000,000	4.625
Maanshan Iron and Steel	1,732,930,000	3.55
Kunming Machine Tools	65,000,000	4.00

Market Capitalization of H Shares as of February 28, 1994 (HKD mil.)

SPC	4,410
Tsingtao Brewery	2,862
Guangzhou Shipyard	645
Beiren Printing	463
Maanshan Iron and Steel	6,152
Kunming Machine Tools	260
	14,792
	(0.56 Pct.)
Total Market Capitalization as of February 28, 1994	2,641,697
	(100 Pct.)

Source: The Securities Journal, February 1994 Trading Record

Exhibit 5 — Hong Kong Futures Exchange: Selected Indicators

	1988	1989
(D) Hang Seng Index Average Daily Turnover (no. of contracts)	567	960

	1990	1991
(D) Hang Seng Index Average Daily Turnover (no. of contracts)	952	2004

	1992	1993
(D) Hang Seng Index Average Daily Turnover (no. of contracts)	4316	9597

Sources: Stock Exchange of Hong Kong Ltd. and Hong Kong Futures Exchange Ltd.

Exhibit 6 — Stock and Futures Market Intermediaries

Number of persons registered by the SFC under the Securities Ordinance and Commodities Trading Ordinance:

	1989	1990	1991
Securities	1,206	1,230	1,187
Futures	153	154	146

	1992	1993
Securities	1,200	1,173
Futures	159	168

Note: The figures include both dealers and investment advisors register with the SFC.

Number of local and overseas dealers:

	1989	1990	1991
Local Securities Dealers	666	656	574
Local Futures Dealers	65	62	62
Total	731	718	636
Overseas Futures Dealers	37	39	36
Overseas Securities Dealers	138	134	143
Total	175	173	179

	1992	1993
Local Securities Dealers	547	476
Local Futures Dealers	65	69
Total	612	545

Overseas Futures Dealers	41	49
Overseas Securities Dealers	150	177
Total	191	226

Note: Similar statistics are not available for advisors.

There were 22 registered U.S.-controlled corporate securities dealers as of March 31, 1994, including:

Bank of Canton (nominees) Ltd.
Bear Stearns Asia Ltd.
Capital House Investment Management (Asia) Ltd.
Dean Witter Reynolds (Hong Kong) Ltd.
Fidelity International Investment Advisors Ltd.
Goldman Sachs (Asia) Ltd.[1]
Jefferies Pacific Ltd.
Kidder Peabody & Company Ltd.
Lehman Brothers Asia Ltd.
Lehman Brothers Securities (HK) Ltd. [1]
Merrill Lynch Asia Pacific Ltd.
Merrill Lynch Hong Kong Securities Ltd. [1]
Morgan Stanley Asia Ltd.
Morgan Stanley Hong Kong Securities Ltd. [1]
Paine Webber International (Asia) Ltd.
Pruasia DBS Ltd.
Prudential Bache Securities (Hong Kong) Ltd.
RNB Finance (Hong Kong) Ltd.
Salomon Brothers Hong Kong Ltd. [1]
Smith Barney Shearson (Hong Kong) Ltd.
Tele-Art Securities (HK) Ltd. [1]
Tiedemann Securities Ltd. [1]

[1] Denotes member of SEHK

There were 11 registered U.S.-controlled corporate commodities dealers as of March 31, 1994, including:

Bear Stearns HK Ltd.
Best Profit Commodities Ltd.
Dean Witter Reynolds (Hong Kong) Ltd.
Hoare Govett Asia Futures Ltd.
Merrill Lynch Futures (Hong Kong) Ltd.
Morgan Stanley Futures (Hong Kong) Ltd.
Paine Webber International Futures (Asia) Ltd.
Prudential-Bach Securities (HK) Ltd.
Lehman Brothers Asia Ltd.
Salomon Brothers Hong Kong Futures Ltd.
Smith Barney Shearson (Hong Kong) Ltd.

Similar statistics for investment advisors are not available.
Source: Hong Kong Government Financial Services Branch

INDIA

BANKING

SUMMARY

Although India has begun to modify its decades-old policy of heavy government intervention in the financial sector, government influence in the banking sector still remains quite dominant. Public sector banks account for nearly 90 percent of India's banking activities. Deposit and lending rates are regulated. Reserve requirements on banks continue to be quite high. And a significant percentage of lending must be to government-selected priority sectors.

Some limited liberalization has occurred, however. After a long hiatus, the government has begun issuing new banking licenses to private sector applicants. Reserve requirements have been reduced. Government ownership in the largest bank in the country has been diluted. And new standards for capital adequacy and accounting have been introduced.

Foreign banks face significant restrictions on entry and expansion. Subsidiaries are prohibited. The number of foreign bank branches continues to be connected to the size of the presence of Indian banks in the applicant's home country. This has materially affected both the ability of U.S. banks to enter India and expansion by those U.S. banks already established in the country. Recently, the policy has been applied a little less stringently as the government permitted eight new foreign bank branches to be established in 1993.

India has introduced capital requirements based to some extent on the Basle Accord. However, branches of foreign banks must meet the requirements on the basis of locally held capital; parent capital is not taken into account. Moreover, foreign banks were required to achieve the specified levels before their Indian competitors.

In addition foreign banks pay the basic corporate tax rate of 55 percent rather than the 40 percent applied to local bank profits. In some respects, U.S. and other foreign banks receive better than national treatment, notably in lower requirements to lend to priority sectors (small businesses, exporters, and the agricultural sector) at concessional interest rates.

There are currently 27 foreign banks with 150 branches in India. They have approximately 7 percent of total banking assets. Three U.S. banks have established branches in the country and hold nearly 40 percent of total deposits in foreign banks.

DESCRIPTION OF THE MARKET

All but the smallest of India's banks were nationalized in 1969. Interest rates were largely fixed, competition was suppressed by denying new domestic entry, banks were "encouraged" to establish rural branches, a significant percent of overall lending was required to be

directed to priority sectors, onerous reserve requirements were imposed (which were an important source of finance for public sector spending), and appointments of bank officials were influenced by political considerations.

One of the goals of Indian policy following the nationalizations was the extension of financial services throughout the country, in particular to rural areas where establishment of offices might not be justified on a purely commercial basis. As a result, branches of public sector banks grew dramatically, from 7,015 in 1969 (when 14 private banks were nationalized) to 56,998 by June 30, 1993. In contrast, branches of the foreign banks increased modestly from 130 to 150. The average population per branch was reduced to 11,000 on March 31, 1993, compared to 65,000 at the time of 1969 nationalization.

The following table provides data on branches, deposits, and loans in billions of rupees for major public sector banks as of March 31, 1993:

Name of Bank	Branches	Deposits	Loans
State Bank of India	8,736	663.2	447.0
State Bank of Hyderabad	729	38.6	22.4
State Bank of Patiala	599	34.2	20.8
State Bank of Travancore	615	32.1	19.0
Satte Bank of Bikaner & Jaipur	709	29.2	17.1
State Bank of Mysore	516	22.5	13.3
State Bank of Saurashtra	344	17.1	10.7
State Bank of Indore	338	14.9	9.2
Bank of Baroda	2,408	209.8	117.8
Bank of India	2,381	195.2	115.5
Punjab National Bank	3,091	182.4	99.2
Canara Bank	2,048	164.7	80.4
Central Bank of India	3,042	138.2	68.1
Indian Bank	1,374	114.8	77.4
UCO Bank	1,791	100.0	58.1
Indian Overseas Bank	1,308	95.0	53.7
Union Bank of India	1,867	93.1	44.9
Syndicate Bank	1,558	88.7	42.3
Allahabad Bank	1,803	76.9	39.6
United Bank of India	1,326	61.5	29.2
Dena Bank	1,117	41.4	19.9
Bank of Maharashtra	1,133	38.7	18.5

Source: Public sector banks, 1992-93, Indian Banks' Association

Financial Sector Reform

In the late 1980s, India began to reconsider its policies in the financial sector. A special committee, headed by former Reserve Bank Governor Narasimham, was appointed to study the banking system. That committee's report in November 1991 included a number of wide-ranging recommendations, some of which the government is in the process of implementing. Some of the major measures relating to the banking sector follow:

- Licensing of new private sector banks. Nine applications have been approved, and three licensees have begun operations.

- Progressive relaxation of ceilings on bank deposit rates and floor lending rates.

- Removal of the requirement that public sector enterprises channel their banking business through state-owned banks.

- Sale at auction of government securities and establishment of trading corporations to develop a secondary market in government securities. (This should allow reduced reliance on bank financing, at subsidy, of government debt.)

- Introduction of bank capital adequacy requirements based on those established by the Basle Committee and introduction of new accounting practices.

- Changing policy to allow state-owned banks to go to the market to raise the additional capital necessitated by the capital adequacy and accounting standards, thus diluting government ownership. The State Bank of India, the largest public sector bank in India, was the first to take this step and now has government ownership of 70 percent.

- Allowed additional foreign bank branches.

- Reduction in very high bank reserve requirements.

- The lending rate structure on certain priority sector categories has been simplified to reduce the subsidy to borrowers and thereby the adverse impact on banks' profitability.

- Branch licensing was partially abolished, providing domestic (but not foreign) banks with greater flexibility to open, close, or merge branches.

- Establishment of a Board for Financial Supervision to provide enhanced supervision of banks.

Privatization

In part due to pressure of funding requirements needed for state-owned banks to comply with the new capital standards and to cover problem loans, the government has allowed state-owned banks to approach the capital market to sell equity to the public. The first to take this step was India's largest bank — the State Bank of India — in which government ownership was reduced to 70 percent through an equity offer to the general public in November 1993. So far, however, there has been no change in management or operations of State Bank. Other nationalized banks are also expected to reduce their share of public ownership over the next few years.

The Reserve Bank of India (RBI — the country's Central Bank) has approved nine applications for new private sector banks as of March 1994. Unit Trust of India (UTI) Bank Ltd was the first to begin operations in April 1994. New banks must provide paid-up capital of Rs 1 billion ($320 million); foreign firms can hold up to 20 percent equity, and nonresident Indians 40 percent in new banks. Although these changes represent a significant shift, the legacy of prior Indian financial sector policies is a banking sector heavily dominated by state-owned banks, which account for approximately 88 percent of deposits and loans. Regional private banks handle 5 percent of the market, and foreign banks — located in metropolitan areas and concentrating on overseas transactions — account for the remaining 7 percent.

There has been rapid expansion of the banking sector. Aggregate bank deposits as of February 18, 1994, totalled Rs 3.10 trillion (nearly $100 billion), up 17 percent from a year earlier, following growth of 16 percent in 1992/93. Gross bank credit as of February 18, 1994, reached Rs 1.63 Trillion ($52.6 billion), up 9.3 percent from a year ago. Of this amount, industrial loans accounted for 93 percent. The remainder went to government agencies for food procurement.

The following table illustrates the broad structure of the industry (in billions of rupees):

Banks	Deposits		Loans	
	1991/92	1992/93	1991/92	1992/3
Public Sector	2,358.8	2,656.8	1,440.2	1,549.0
State Bank of India	601.9	663.2	443.4	476.9
SBI Associates	156.7	188.7	95.7	112.5
Public Banks	1,600.2	1,804.9	901.1	959.6
Foreign Banks	168.9	209.0	92.0	105.6
Private Banks	122.9	154.4	64.6	80.3
Total	2,650.6	3,020.2	1,596.8	1,734.9

Source: Indian Banks' Association : 1992/93

Recent Developments

One consequence of Indian policies was the growth of bad loans. Nonperforming assets form a large portion of bank portfolios — 14.5 percent of outstanding loans on March 31, 1992 (Rs 173.9 billion), up from 13.6 percent a year earlier. The government is pressing nationalized banks to recover doubtful debts, and established special tribunals for speedy loan recovery in late 1993.

The Reserve Bank (RBI) has simplified the interest rate structure in the past three years. The ceiling is now 10 percent for a one-year certificate of deposit, and the floor for commercial bank loans has been reduced gradually from 17 percent to 14 percent as of April 1, 1994. Firms, however, generally pay rates of 17 to 22 percent or more after accounting for a variety of bank charges.

Commercial banks extended loans of Rs 210.7 billion in 1992/93, up sharply from Rs 79.86 billion the previous year. Of this amount, commercial loans, including loans for the priority sectors, accounted for 90 percent. The remainder supported food procurement.

Banks now face stiff competition from capital markets where well established firms can raise loans at lower interest rates than charged by commercial banks. This table shows sectoral deployment of gross loans in billions of rupees:

	1991/92	1992/93	Percent Share
Gross Bank Loans	79.86	210.66	100.0
Food Procurement	1.64	20.73	9.8
Priority Sector	25.10	43.33	20.6
Industrial Loans	25.82	115.37	54.8
Loans to Trade	2.44	7.55	3.6
Others Loans	24.86	23.68	11.2

Source: Government of India economic survey, 1993/94

Foreign Banks

There are 150 branches of foreign banks, which mainly operate in metropolitan centers. They finance primarily trade and extend loans to large industrial houses. They account for 7 percent of total deposits, and have a small exposure in the priority sector. Most foreign banks in the country have diversified their operations by opening merchant banking divisions, mobilizing special deposits by nonresident Indians, security operations, and management consultant services. In addition, there were 24 representative offices of foreign banks as of March 1993.

Foreign banks account for 0.3 percent of total bank branches, 7 percent of bank deposits, and 6 percent of total loans as of March 31, 1993. Deposits per employee on March 31, 1993 averaged Rs 15.8 million for foreign banks compared to Rs 3 million for public sector banks. Loans per employee for foreign banks were 8 million rupees vs. a modest 1.8 million rupees for public sector banks. Over staffing and manual operations contributed to this situation in public sector banks. Foreign banks enjoy a positive reputation for customer satisfaction, and continue to increase their business even with limitations on the number of branches. Deposits in 1992/93 grew by 23.7 percent compared to 12.7 percent for public sector banks.

The following table summarizes foreign banking operations in India (as of March 31, 1993), including the number of branches, deposits, and loans in billions of rupees:

Name of Bank (Number of Branches)	Loans	Deposits
Citibank N.A. (6)	50.1	21.0
ANZ Grindlays Bank (56)	44.6	18.6
Standard Chartered (24)	23.2	7.9
Hong Kong Bank (21)	18.7	11.4
American Express (4)	15.7	14.6
Bank of America NT & SA (4)	15.6	3.6
British Bank of the Middle East (1)	6.6	2.1
Bank of Tokyo Ltd. (3)	5.5	4.0
Deutsche Bank AG (2)	5.0	4.4
ABN-Amro Bank N.V. (4)	3.0	3.2
Credit Lyonnais (1)	3.0	2.0
Banque Nationale de Paris (3)	2.9	2.7
Abu Dhabi Commercial Bank Ltd. (1)	2.1	0.9
Bank of Bahrain and Kuwait BSC (1)	1.9	0.7
Oman International Bank Saog (1)	1.9	1.5
Banque Indosuez (1)	1.9	0.8
Societe Generale (1)	1.9	0.4
Mashreq and PSC (1)	1.9	1.1
The Sakura Bank Ltd. (1)	1.8	0.8
The Bank of Nova Scotia (1)	0.6	2.1
Barclays Bank PLC (1)	0.5	1.0
The Sanwa Bank Ltd. (1)	0.5	0.8
Sonali Bank (1)	0.1	0.1
Total (140)	209.0	105.6

U.S. PRESENCE IN THE MARKET

Citibank, Bank of America and American Express Bank operate 14 branches domestically and account for nearly 40 percent of total foreign bank deposits. Assets of these banks totalled $3.5 billion on March 31, 1993, compared to $2.5 billion in 1989. The U.S. banks are leaders in consumer banking, custodial services, factoring, and other sophisticated banking services, and are among the most profitable. Bank of New York, Chase Manhattan Bank, Chemical Bank and Bankers Trust have one representative office each. In August 1994, the RBI approved the application of Chase Manhattan to commence operations in India.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Entry of foreign banks is regulated by the RBI and all banking activities are governed by the Banking Regulation Act of 1949 (which has been amended over time) and the Foreign Exchange Regulation Act of 1973. (The latter act has undergone major changes with many of its restrictive aspects removed.) Foreign banks may not establish subsidiaries.

India's basic policy on foreign banks opening branches has been one of allowing entry and expansion roughly comparable to Indian bank presence in the applicant's country. As Indian banks have not been major international players (with 106 overseas branches, plus 13 representative offices, 7 joint ventures, and 10 subsidiaries), not very many new foreign banks have been able to enter the Indian market since 1948. Liberalized policies since 1991 have opened the door for a number of additional foreign banks; the RBI has approved applications for banks from the United States, the Netherlands, Germany, Thailand, Mauritius and Switzerland, and is actively considering several more applications.

Once approved for entry, foreign banks must capitalize their first two branches at $10 million each; an additional $5.0 million is required for a third branch. Subsequent branches do not require additional capital.

The Reserve Bank fixes the number of authorized branches upon granting the entry license, and does not usually allow foreign banks to have both representative and branch offices. However, there are cases of foreign banks being present as both. The restriction on the number of branches applies only to foreign banks. One U.S. bank that collects accounts receivable would like to open several one-person offices to speed processing. A second U.S. bank with extensive credit card operations would like to open a number of regional processing centers to service the accounts. Under current practice, doing so would require closing down an existing branch. These arbitrary and rigid restrictions limit the ability of U.S. banks to expand and develop new services for the Indian market.

According to the Ministry of Finance, the policy of expansion of branches in India by foreign banks is decided by RBI taking into account several factors, of which reciprocity is one. The ministry noted that American Express was allowed to open a branch in Bangalor in 1992.

The Finance Ministry states that there is no branch for branch reciprocity and provided the following information regarding Indian banks' presence in the United States and U.S. banks presence in India.

Indian Banks in the United States	
Name	**Form(s) of Establishment**
State Bank of India	5 branches/agencies
	1 subsidiariary
	1 representative office
Bank of Baroda	1 branch
Bank of India	2 branches/agencies
U.S. Banks in India	
American Express	4 branches
Citibank	6 branches
Bank of America	4 branches

Otherwise, foreign banks are subject to rules and regulations very similar to those applicable to domestic competitors. In some respects, foreign banks have advantages. They are not required to open branches in rural areas, or to make loans to the agricultural sector. Domestic Indian banks are required to extend 40 percent of their loans at concessional rates to the "priority sector," consisting largely of the agricultural sector, exporters, and small businesses. Foreign banks are subject to slightly less rigorous requirements. Since July 1993, foreign banks have been required to extend 32 percent of their loans to the priority sector. However, they are exempt from compulsory loans to the agricultural sector. Shortfalls in meeting the target can be balanced by depositing funds with the Small Industries Development Bank of India (SIDBI), with an annual return of 10 percent.

An important element of discrimination was removed recently when the restraint on Indian public sector firms doing business with foreign banks was lifted. In late 1993 and early 1994, these firms have worked with foreign banks to syndicate loans and conduct other transactions.

In April 1992, the RBI followed the Basle Group's recommendations in prescribing new risk-weighted capital requirements. Indian banks had to reach a 4 percent ratio by March 1993, and must achieve 8 percent by March 1996. Indian banks with an international presence are required to reach 8 percent by March 1995. Foreign banks were required to reach 8 percent of risk-weighted assets by March 1993.

The RBI views the capital base of a foreign bank as foreign funds deployed in India, which it defines as foreign currency loans extended to the branch by the parent, initial capital, and any subsequent increases in capitalization. Net funds deployed are required to be no less than 3.5 percent of aggregate liabilities, and no more than 25 percent of the capital base can be lent to any one borrower, or more than 50 percent of this amount to any single industrial group. Domestic banks are subject to the same requirements based on their capital.

Section II of the Banking Regulation Act requires all banks to maintain in India an amount equivalent to 20 percent of total annual profits from Indian operations, and the RBI requires that these holdings be in rupees. The RBI does not allow banks to hedge these required rupee holdings, which limits the ability of U.S. banks to guard against rupee depreciation.

U.S. banks do not face any constraints in funding their business operations. Even the public sector firms, which were previously not allowed to open accounts with foreign banks, have now established normal banking relations with them. No restriction is imposed on raising funds through money market instruments, including overseas capital.

The 1994/95 budget has reduced the basic tax rate from 45 percent to 40 percent for Indian banks and from 65 percent to 55 percent for foreign banks. A 15 percent surcharge is levied on Indian banks; foreign banks are exempt.

INDIA

SECURITIES

SUMMARY

While India's capital markets have a long history, it is only recently that they have grown significant in size. There are presently 23 stock exchanges serving an estimated 25 million investors, including one over-the-counter exchange. A wide variety of equity and fixed income instruments are available to investors. The stock exchanges have become important sources of financing for Indian corporations, reducing the previously dominant role of commercial banks and state-owned financial institutions. A proposal from the Bombay Stock Exchange for futures trading in individual shares is under consideration.

Capital raised on the stock exchanges increased from Rs 2 billion ($253 million) in 1980/81 to nearly Rs 323 billion in 1993/94, 18.5 percent of funds from savings (about $10.5 billion at exchange rate of Rs 31.50 to a dollar). Much of this growth was driven by the introduction of stock-investment instruments, and tax concessions on long-term capital gains, allowing firms to issue equity at market determined prices that have opened India's capital markets to foreign investors.

Several U.S. financial institutions are participating in the Indian capital markets in various capacities. U.S. and other foreign financial institutions have established joint ventures with Indian financial institutions for merchant banking, investment banking, asset management, and consumer finance. U.S. financial institutions also have been active in underwriting offshore issues by Indian companies, and in managing and marketing mutual funds.

The Securities and Exchange Board of India (SEBI) is responsible for the development and regulation of India's capital markets, investor protection, and advising the government on capital market development. Foreign institutional investors (FIIs) may make portfolio investments in local stock markets, but only subject to registration requirements and certain investor ceilings. Nor are foreign individuals and foreign corporate bodies permitted to make portfolio investments in corporate firms. Foreign investors are concerned by inadequate custodial facilities, lack of transparency in trading operations, and a weak clearance and settlement system.

Although Indian residents are not permitted to invest in foreign securities, the Indian corporate sector may raise funds overseas through issues of GDRs, ADRs, and convertible bonds.

DESCRIPTION OF THE MARKET

Capital Market Growth

Since the structural reforms of 1985, India's once sleepy capital market has grown substantially in size. Capital raised through new equity issues, bonds, and other capital market instruments totalled Rs 323 billion ($10.5 billion at an exchange rate of Rs 31.50 equals $ 1.00) in 1993/94 versus only Rs 2.0 billion in 1980/81. Moreover, there has been a substantial increase in the percentage of India's gross domestic savings being placed in capital market instruments; 18.5 percent in 1993/94 versus 9.1 percent in 1991/92.

Of total funds raised in India's capital markets in 1993/94, raising by private sector firms accounted for 62.5 percent of the total, mutual funds raised 26.6 percent of the total, and public sector firms raised the remaining 10.9 percent. Equity and preferred stock have been the leading securities market instruments, accounting for 52 percent of total funds raised. Bonds (both convertible and nonconvertible) have accounted for the remaining 48 percent. The absolute number of shareholders is large — over 25 million. But even this amount represents only 3 percent of the total Indian population.

In addition to conventional equity/preference shares and debentures, Indian securities firms are now able to offer a wide variety of securities products: triple-option convertible bonds, deep-discount bonds, zero-interest partly convertible debentures, cumulative convertible redeemable preference shares to be converted into equity, equity shares with detachable warrants, and floating rate bonds. Indian firms no longer limit themselves to raising funds earmarked for individual projects; they use capital proceeds to retire debt, invest in subsidiaries, and provide working capital. Some foreign banks and nationalized banks offer over-the-counter trading for government bonds.

Stock Exchanges

There are presently 23 stock exchanges serving an estimated 25 million investors, including one over-the-counter exchange. Of the 23, the largest stock exchanges are in Bombay, Calcutta, Madras, Delhi, and Ahmedabad. The stock exchanges are managed by their governing boards and executive directors, which establish their operating rules. They are subject to regulation by the Ministry of Finance and the SEBI.

Market capitalization at the Bombay Stock Exchange, as of June 30, 1994, was Rs 4.45 trillion ($142 billion) — 50 percent of GDP — up from Rs 908 billion in March 1991 (17.1 percent of GDP). The average price/earnings ratio (39.4 on October 19, 1994, compared to a P/E of 32.8 a year ago) is quite high by international standards. The following table provides data on selected major stock exchanges (many of which list the same stocks), with capitalization expressed in billions of rupees, as of March 31, 1993:

Major Stock Exchanges — Composition of Capitalization as of March 31, 1993
(in billions of rupees)

Exchange	Firms Listed (Number)	Equity	Bonds	Other	Total Capitalization
Bombay	2,903	245.3	183.1	1.0	2,109.5
Calcutta	2,475	138.7	49.7	0.8	1,118.3
Delhi	2,164	204.9	93.7	0.7	1,419.5
Ahmedabad	1,015	120.0	80.5	0.2	906.5
Madras	748	150.4	57.6	0.6	1,010.5
Hyderabad	274	80.3	21.7	0.2	229.6
Bangalore	369	76.7	58.7	0.2	687.3
Kanpur	793	35.2	58.5	0.1	285.6
Guwahati	218	16.4	9.9	0.0	369.0
All-India	6,925	340.3	192.6	2.4	2,528.5

Note: Columns do not add to the all-India total because the same stocks are listed at more than one exchange.

The Over-the-Counter Exchange of India (OTCEI) is for small investors and small companies. It commenced operations in September 1992 in Bombay and is similar to the National Association of Securities Dealers Automated Quotation Market in the United States. In late 1993, it began operating regional windows in Delhi and Madras, and now has representative offices in 18 major cities.

The all-Corporate National Stock Exchange of India Ltd. (NSC) is an automated stock exchange that will introduce scripless, screen-based trading throughout the country. NSC will have exchanges at Bombay, Calcutta, Delhi, Madras, and Ahzmedabad followed by regional Stock Exchanges and additional trading flow at regional levels. The Industrial Development Bank of India (IDBI) is in charge of developing the system. It began operating in June 1994, with operations in money market debt instruments such as the dated securities and Treasury bills of the government of India. It is an electronic order-driven exchange located in Bombay, with trading members connected by phone lines to the NSE's Central Computer. The NSE is expected to introduce equity trading in November 1994.

The Securities and Exchange Board of India (SEBI) is responsible for the development and regulation of India's capital markets, investor protection, and advising the government on capital market development. It was constituted as a nonstatutory body on April 12, 1988, and given regulatory authority on January 30, 1992. SEBI has drafted and issued a variety of regulations governing transactions by stock brokers, merchant bankers, portfolio managers and mutual funds. Earlier, under the authority of the Capital Issues (Control) Act, 1947 (repealed on May 29, 1992), functions relating to the issue of capital and its pricing were handled by the Controller of Capital Issues within the Ministry of Finance.

Securities are traded on the stock exchanges through a limited number of licensed brokers, but a large number of sub-brokers and their agents operate through the registered brokers. SEBI has imposed stricter requirements on brokers, requiring registration and stricter financial disclosure norms. It also has pushed to have brokers clearly separate trading on their own account from trades executed for customers.

Until recently the local "badla" system (rolling over business to the next session) operated as a futures market. Securities traded at the major stock exchanges were classified into "specified" (forward transactions under the "badla" system) and "non-specified" or current transactions. This system was widely criticized for promoting market volatility, manipulative practices, and insider trading. To reduce undue speculation and to promote transparency, SEBI banned "badla" trading and directed brokers to eliminate their future positions by mid-March 1994. A new futures trading system is being developed.

Following increased trading in the stock exchanges, and to provide safety to investors, three credit rating agencies are in operation: the Credit Rating Information Services of India Ltd. (CRISIL); the Investment Information and Credit Rating Agency of India Ltd. (ICRA), and the Credit Analysis and Research Ltd. (CARE). These agencies generally rate the debt instruments of firms seeking to raise resources from the capital market. Ratings are mandatory for debt instruments with maturity periods exceeding 18 months. CRISIL has extended technical assistance and training facilities to overseas countries, including Malaysia and Israel.

Foreign financial institutions may act as securities custodians. Currently there are six securities custodians — Stock Holding Corporation of India, Ltd., HongKong Bank, Citibank, Standard Chartered Bank, the State Bank of India, and Deutsche Bank. The Industrial Credit and Investment Corporation of India also plans to set up custodial services.

Some of the major bottlenecks at the Indian stock exchanges are (a) lack of transparency due to inadequate computerization and absence of screen-based trading; (b) inadequate custodial services; and (c) delays in physical delivery of certificates (delivery at times takes up to six months although generally 50 percent of the total value of the transactions must be paid at the time of purchase). The Bombay Stock Exchange does not yet do electronic transfers and the stock exchanges do not trade in indexes, derivatives, or other forms of sophisticated investments.

The 1994/95 budget reduced the corporate tax rate from 45 and 50 percent to a uniform 40 percent rate, increasing investor interest in equities. In addition, the holding period for determining long-term capital gains on mutual funds, including the government-owned Unit Trust of India (UTI), has been reduced from 36 months to 12 months for domestic residents. The budget proposes to establish a central depository system to support scripless trading.

Mutual Funds

The government has permitted mutual funds to be established both in the government and the private sector. The public sector UTI is the dominant player, with a market share of about 80 percent. The public sector Life Insurance Corporation and the General Insurance Corporation also have large mutual funds. In addition, a number of private sector funds are springing up, of which a handful have American participation.

SEBI guidelines for mutual funds require that a close-ended scheme must raise a minimum of Rs 200 million, and an open-ended scheme must raise Rs 500 million. Two close-ended Indian mutual funds raised over $1 billion in offshore funds in February 1993. India Fund Inc. raised about $510 million in an issue underwritten by Oppenheimer Co. Inc. and Barclays de Zoete Wedd Ltd. as lead managers. Another $525 million was raised by Morgan Stanley for its India investment fund. These successes have attracted substantial interest in Indian markets. Many more institutional players — foreign pension funds and public provident funds — are now being allowed to enter the market. These funds are investing directly in the stock market, in addition to placing their money with Indian fund managers.

Foreign financial institutions established in India may manage local mutual funds. They are required to be registered with the SEBI.

Foreign Institutional Investment

Foreign Institutional Investors (FIIs), such as foreign pension funds, foreign mutual funds, and foreign investment trusts can invest in domestic Indian securities instruments. However, FIIs as a group may not hold more than 24 percent of the issued capital in any firm, and any single FII is limited to a 5 percent ceiling. FIIs enjoy a concessional tax rate of 10 percent on long-term capital gains (securities held for 12 months), and 30 percent on short-term capital gains (securities held for less than 12 months); Indian firms are charged 30 and 40 percent, respectively.

Overseas investors generally trade on cash versus delivery basis, and the current clearance and settlement process is very cumbersome. The Hong Kong and Shanghai Bank and Citibank are the principal depositories for securities holdings by FIIs.

FII buying stimulated the secondary market in 1993/94, and contributed to pushing the RBI index of equity prices (1980/81=100) up to 1434.6 on February 12, 1994, from 1024.6 a year earlier. As of August 31, 1994, the SEBI had approved 222 FIIs with a cumulative net investment of US$2.6 billion, nearly two percent of market capitalization. Most of the funds operated by the FIIs represent American funds. Estimates are that the Bombay Stock

Exchange can absorb $2-3 billion annually. Foreign brokers are also allowed to assist FIIs in executing investment decisions.

International Issues

The Reserve Bank of India permits Indian firms to raise funds overseas, but only through issues of global depository receipts (GDRs) or convertible bonds that can be listed overseas. American depository receipts (ADRs) also are permitted, but Indian firms find it difficult to meet SEC listing standards. Indian firms have successfully launched Euro-issues in overseas markets. Early in 1993, several large firms entered the international markets by issuing global depositary receipts and convertible bonds. Based on their success, smaller firms also plan to enter the Euro-issue market to raise funds for modernization and expansion to reduce/retire debt, and to set up overseas subsidiaries. Euro-issues including SDRS netted $2.6 billion in 1993/94. Both U.S. and European banks have generally been the lead managers for these issues.

Indian residents are not permitted to purchase foreign securities.

U.S. PRESENCE IN THE MARKET

Several U.S. companies have joined with Indian partners to offer financial services in India. J.P. Morgan has a 40 percent joint venture with Industrial Credit and Investment Corporation of India (ICICI) for merchant banking services. It is called ICICI Securities and Finance Ltd. and it is a full-fledged investment bank and securities company. Morgan Stanley has a 75 percent stake in an asset management company, which operates a mutual fund; Alliance Capital also holds 80 percent of an asset management company. Kemper Financial Services, Soros Fund Management, and Pioneer Fund all hold one-third of the equity in joint ventures with Indian financial firms to operate mutual fund programs. Bank of America has received FIPB approval in principle to hold 75 percent of the equity in a separate investment banking facility; GE Capital Corporation and the Housing Development Finance Corporation (HDFC) will offer consumer financing services in a 50/50 joint venture called Countrywide Leasing. While foreign banks are permitted to engage in fund management activities such as mutual funds, foreign banks with operations in India have not entered this area so far. Many U.S. financial institutions such as Merrill Lynch, Morgan Stanley, and Goldman Sachs have been lead underwriters of GDRs issued in the Euro-market by Indian companies.

The Banking Regulation Act was amended in 1983 to permit commercial banks to establish merchant banking subsidiaries and a number of nationalized banks have done well in the merchant market. U.S. banks are active players in this area. Following are the different types of merchant bankers:

- Public financial institutions such as the Industrial Credit and Investment Corporation of India (ICICI) and Industrial Finance Corporation of India (IFCI).

- Commercial banks such as State Bank of India, Canara Bank, and the merchant banking wings of Grindlays, Citibank, and Standard Chartered.

- Private nonbank firms like JM Financial and Investment Consultancy Services, the Credit-Capital Group, Champaklal Investment and Financial Consultancy, and DSP Financial Consultant Ltd.

With respect to details of foreign institutional investors (FII) in Indian securities markets, the following U.S. intermediaries were registered with SEBI as of October 19, 1994:

U.S. Intermediaries Registered with SEBI as of October 19, 1994	
Pension Funds	8
Unit Trusts	14
Mutual Funds	42
Institutionally Owned funds	1
Sub-accounts of funds	60
Total Accounts:	125

The U.S. accounts for the largest number of FIIs registered with SEBI as well as for the largest number of active FIIs.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There is no limit on the extent of foreign equity participation in nonbank financial subsidiaries engaged in securities activities. These are subject to minimum capital requirements and foreign ownership must be approved by the Foreign Investment Promotion Board, the RBI, and the SEBI. However, the Indian government is flexible on whether merchant banks can establish 100 percent foreign-owned entities.

Foreign securities firms cannot operate on the Indian stock exchanges. They must go through registered brokers to execute stock exchange transactions.

The Reserve Bank of India permits the opening of representative offices by foreign securities firms, subject to the conditions that no income is earned by the office and all expenses are paid by remittances from abroad.

The guidelines for the establishment of private banks prohibit the establishment of a subsidiary or a mutual fund for at least three years after the bank's establishment, although this regulation may soon be liberalized.

Foreign institutional investors such as foreign pension funds, foreign mutual funds, and foreign investment trusts are permitted to invest in Indian primary and secondary markets, subject to a ceiling of 24 percent of the issued capital for the total holdings of all registered FIIs. A single FII holding in any one firm is limited to 5 percent of the total issued capital of the company. FIIs cannot operate directly in Indian markets. They must rely on Indian firms for a variety of services. Foreign individuals and corporate bodies, except for nonresident Indians, are not permitted to make portfolio investments in Indian securities.

Indian companies are permitted to issue equity and equity-related instruments to international investors with RBI permission. U.S. investment banks may underwrite international offerings by Indian firms. Indian residents are not allowed to invest in portfolio securities overseas.

Rules are transparent in theory, but some difficulty is experienced in practice. However, the government is receptive to comments and is attempting to eliminate many of the rigidities of the past.

INDONESIA

BANKING

SUMMARY

The government of Indonesia, through the Ministry of Finance, owns the largest banks in the country. As of December 31, 1993, the seven state commercial banks controlled 52.7 percent of all outstanding credits. However, their market share has been declining following certain reforms in 1988 that included expanding the base of privately owned banks. The major challenge at the moment is to strengthen the capital of state-owned banks and to improve their loan portfolios.

As part of the 1988 reform measures, Indonesia lifted a 16-year ban on new foreign bank entry. However, new entrants are limited to holding "at most" an 85 percent equity interest in a joint venture Indonesian bank. Such foreign joint venture banks are subject to a higher capital requirement than domestic entrants but are able to offer foreign exchange services immediately after establishment. New domestic banks must wait at least two years before they can receive approval to engage in foreign exchange activities. Foreign banks are allowed to establish multiple branches in Jakarta and to open one sub-branch each of Indonesia's seven largest cities. Each sub-branch may establish various cash offices, which can accept deposits or cash checks. As a form of entry, branches are not permitted. Foreigners may acquire up to a 49 percent interest in domestic banks listed on the Jakarta Stock Exchange.

Four U.S. banks — Chase, Citibank, American Express, and Bank of America — established branches prior to the 1972 ban on new bank entry. These banks are able to offer the same banking services as domestic banks. One U.S. bank has a minority interest in a joint venture bank. Seven other U.S. banks maintain representative offices in Jakarta.

DESCRIPTION OF THE MARKET

State Banks

Indonesia's seven state commercial banks were established originally to meet the credit requirements of individual sectors of the economy. However, time and deregulation has eroded that specialization. Most state banks operate now as commercial banks throughout all sectors of the economy. Nevertheless, state banks continue to be the largest financial institutions in the Indonesian banking system. In 1988, the seven state banks held 71 percent of the total outstanding credit assets. By 1993, their relative market share had slipped to 52.7 percent.

Private Banks

Private commercial banks are small by comparison to their state-bank counterparts, although they are generally better capitalized — and some are listed on the stock exchange. Private banks have been the mainstay for most of the expansion of the banking system since 1988, with 95 new private domestic banks being established within the last five years. In addition, private domestic banks have set up 91 percent of the 2,590 new bank branches since 1988, resulting in an increase in their relative market share of outstanding credit from 28 percent in 1988 to 47 percent in 1993.

Foreign Banks

Foreign banks and joint venture banks have kept pace with the expanding sector. Foreign banks have maintained their market share by adding branches following the relaxation of certain restrictions on foreign bank branches. Their capital adequacy is the strongest among Indonesia's banks. Foreign banks tend to focus their banking activities mainly on the offshore credit requirements of Indonesian clients, as well as handling the offshore banking needs of Indonesian corporations and Indonesians abroad.

Regional Banks

Regional development banks have a relatively small share of the financial sector's assets, accounting for just 2 percent of outstanding credit in 1993. Like the state-owned banks, their activities have shifted away from their original charter — the funding and implementation of development projects — toward more general commercial banking.

Deregulation

Indonesia has been in the process of slowly deregulating its banking system since 1983, when the government first eliminated ceilings on interest rates and replaced credit ceilings with other means of implementing monetary policy, i.e., reserve requirements and open market operations. In October 1988, the government introduced reforms that included the following:

- Permitted the licensing of new banks, including joint ventures with foreign banks;
- Allowed domestic banks to establish branches throughout the country, and permitted foreign banks to open branches in six major cities outside of Jakarta;
- Abolished the requirement that state-owned enterprises place all of their deposits in state-owned banks, and authorized those enterprises to place up to 50 percent of their deposits in private banks; and

- Reduced the bank reserve requirement from 15 percent to 2 percent.

As a result of these changes, the number of banks and the amount of banks' outstanding loans increased substantially. In 1988, there were 124 banks in Indonesia with 2,044 branches. By 1993, the number of banks had more than doubled, to 234, and the number of branches had increased to 5,838. The amount of outstanding loans more than tripled in real terms — from 50.7 trillion rupiah in 1988 to 177.5 trillion rupiah in 1993.

Problem Loans

However, the rapid growth of the banking sector led to a deterioration in the quality of loan portfolios. This became apparent in 1991 when the government, responding to an overheated economy, caused in part by the rapid expansion of the banking system, tightened fiscal and monetary policy. Interest rates rose, the growth of credit slowed, and a number of less financially sound borrowers were unable to meet their obligations. The failure of the private Bank Summa in December 1992, caused by poor lending practices and overexposure to the real estate sector, provided perhaps the most vivid demonstration of the poor quality of banks' portfolios.

The seven state-owned banks are the most heavily saddled with nonperforming loans. Concern about loan quality began to receive greater attention in early 1994 when the Indonesian Parliament held hearings on one of the problem loans, a 900 billion rupiah ($430 million) credit extended by Bapindo, one of the state banks, to the Golden Key group, a conglomerate involved in the petrochemical business. In February, Minister of Finance Mar'ie Muhammed told the Parliament that nonperforming loans at the state banks totalled 15 trillion rupiah ($7.1 billion), about 20 percent of total state bank loans, and three times their combined capital.

Deposit Insurance

Indonesia has no deposit insurance. However, depositors at state banks assume the government, as the sole owner of these financial institutions, will stand behind their liabilities. The government is taking steps to inject fresh capital into the banks. In addition, many bankers attribute the large spread between deposit rates and lending rates — about 600 basis points — to the need to recover losses associated with nonperforming loans and to build up capital.

Private and foreign sector institutions appear content to allow state banks to be the price leaders on lending rates. The limited alternatives available to business borrowers in the capital markets contributes to the banks' ability to sustain these relatively wide margins. Although capital markets have begun to develop rapidly within the past few years, banks are still the primary source for corporate financing. For example, about $1 billion in

commercial paper is outstanding, 10 times the amount of just two years ago, but even this amount is less than 2 percent of total bank loans to the private sector.

Regulation

In order to enhance the soundness and stability of the banking system, new prudential regulations were introduced in February 1991. These regulations included capital adequacy targets in line with the standards recommended by the Bank for International Settlements (BIS). The increase in the capital adequacy ratio was designed to reduce the danger that mismanagement of credit risk would lead to a loss by depositors and to dampen a bank's appetite for risky loans by putting greater amounts of the owners' capital at risk. As of December 1993, only 26 banks out of 234 were unable to meet the 8 percent target for capital to risk-weighted assets.

One of the consequences of the reform measures and the troubled portfolios at the state banks was an expansion of the market share accruing to banks in the private sector. This was particularly noticeable in 1993 when the growth of domestic credit early in the year fell below Bank Indonesia's targets because the state banks, struggling to meet capital adequacy ratios, were unable to aggressively expand their loan portfolios. By the end of the year, however, the private banks, whose loan portfolios grew by more than 46.6 percent, had more than made up for the inactivity of their state-owned competitors.

Some private banks are affiliated with a commercial or industrial group. Affiliation with a large conglomerate is no guarantee of the financial backing of the group in the event of a bank failure. To reduce excessive intragroup lending, Bank Indonesia has tightened the restrictions on legal lending limits. For companies within the same group the limit was reduced from 50 percent to either 20 percent or 10 percent, depending on the percentage of equity owned, and for parties affiliated with the bank, the limit is 10 percent of capital. In order to allow debtors ample time to arrange alternative sources of funds, Bank Indonesia is phasing in the new legal lending limits over a three-year period that will require full compliance by March 31, 1997.

U.S. PRESENCE IN THE MARKET

Four U.S. banks — Citibank, Chase, American Express, and Bank of America — enjoy grandfathered status under the Indonesian regulatory system and operate 100 percent owned branches. Although most of these banks concentrate on corporate lending, they are permitted to provide a full range of banking services.

In addition, seven U.S. banks have representative offices that can provide some services, including facilitating trade financing, but they cannot accept deposits or make loans. The seven banks with representative offices are:

Chemical Bank
J.P. Morgan
Bank of Boston
Bank of California, N.A.
Philadelphia National Bank
Republic National Bank
Banker's Trust

A total of 29 joint venture banks have been formed since 1988. Chemical Bank became the owner of a minority interest in a joint venture bank when all joint venture nonbank financial institutions were converted by law into joint venture banks. Bankers Trust also has an interest in a nonbank joint venture leasing company.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In 1972, Indonesia stopped issuing new licenses to foreign banks, and no foreign bank entered the market until 1988. (The 10 foreign banks that owned and operated branches had been established prior to 1972.)

The 1988 financial reforms permitted foreign banks to form a joint venture with a domestic bank, provided the foreign bank was a major bank in its home country, and provided reciprocal access was available to Indonesian banks. The local joint venture partner must have an equity interest of at least 15 percent. In addition, the domestic partner must be a national bank that has received a sound credit rating for at least 20 months.

Capital requirements are higher for foreign banks than for domestic banks. New foreign joint venture banks must have paid-in capital of 100 billion rupiah ($47.6 million), whereas local banks are required to have only 50 billion rupiah ($23.8 million). However, the joint venture banks have the right to engage in foreign exchange business, whereas local banks must be in operation for at least two years before they are permitted to engage in foreign exchange activities. The higher capital requirement operates as an effective barrier to entry.

At least three U.S. banks have considered forming a joint venture bank, but have found potential returns insufficient to justify a $47 million investment.

Foreigners also are restricted from acquiring more than a 49 percent equity stake in a bank listed on the Jakarta Stock Exchange.

Before 1988, the foreign banks that had established prior to 1972 were permitted to have only one branch, which had to be in Jakarta. Since 1988, formal restrictions on adding sub-branches have been relaxed. Foreign banks are now permitted to open additional sub-branches in Jakarta and single sub-branches in seven other cities: Medan, Bandung, Semarang, Surabaya, Denpasar, Ujung Pandang, and Batam Island. Each of the sub-branches is allowed to establish "cash offices," which can accept deposits or cash checks but not engage in other banking business, such as making loans. So far, foreign banks have opened offices in Medan, Surabaya, Bandung, Batam, and Denpasar. The only U.S. bank to open a sub-branch outside Jakarta is Citibank, which has sub-branches in Surabaya and Bandung. Domestic banks are not subject to this restriction on adding branches.

Foreign banks can offer the same banking services as domestic banks. U.S. banks already doing business in Indonesia generally report that they do not feel significantly restricted in their operations. However, limits on the number of foreign personnel, which apply not only to banks but to all foreign companies doing business in Indonesia, are considered restrictions.

In addition, foreign and private domestic banks face differences in treatment compared to state-owned banks. The government and state-owned enterprises are legally required to keep at least 50 percent of their deposits with the state-owned banks, and in practice the percentage may be considerably higher. However, state ownership also brings with it some pressure to implement government policies and, as the Bapindo-Golden Key case discussed above illustrated, sometimes to provide credit to those with political connections.

Regulatory authorities compute capital adequacy ratios and legal lending limits for the foreign bank branches operating in Indonesia — including the four U.S. banks — by using only capital of the branch and not the capital of the parent bank. This restricts the amount of business that these banks can do in Indonesia.

	Percentage of Total Outstanding Bank Credit	
	1988	**1993**
State Banks	71.0	52.7
Domestic Banks	23.1	41.7
Foreign Banks	3.5	3.6
Regional Development Banks	2.4	2.0

Consolidated Balance Sheet — Indonesian Banking System
December 31, 1993
(millions of U.S. dollars)

	State Owned	Private National Banks	Foreign Banks
Assets	43,492	36,234	8,771
Cash in Vault	429	259	16
Deposits at Central Bank	220	275	35
Foreign Assets	2,121	2,701	547
Loans to Govt.	390	25	0
Loans to Govt. Firms	5,010	90	6
Loans Private Sector	29,617	28,593	6,214
Other Assets	5,705	4,291	1,953
Liabilities	43,492	36,232	8,771
Demand Deposits	3,369	4,509	566
Time Deposits	15,443	16,149	704
Foreign Currency Deposits	4,755	5,421	1,933
Foreign Liabilities	2,874	3,195	3,159
Govt. Deposits	3,138	60	17
Import Guarantees	235	347	39
Central Bank Borrowings	942	586	0
Capital	2,316	3,296	946
Other Liabilities	10,421	2,671	1,407

Source: Bank Indonesia

INDONESIA

SECURITIES

SUMMARY

Starting from a relatively small base, Indonesia is slowly beginning to make progress in developing a capital market. The markets for new issues of equities, corporate bonds, and commercial paper are beginning to show signs of progress, although initial volumes are still quite small relative to GDP and other forms of financing, such as bank credit. Conversely, brokerage opportunities are expanding rapidly: average daily turnover of stocks on the Jakarta Stock Exchange has grown from 27,000 shares a day in 1988 to 15 million shares a day in 1993.

Financial reforms instituted in 1987 allowed foreign firms to enter the securities market as underwriters, broker-dealers, and investment managers. However, entry is conditioned on foreign firms forming a joint venture with an Indonesian firm. At a minimum, an Indonesian partner must have a 15 percent ownership stake. In addition, foreign-owned joint venture securities firms are subject to discriminatory capital requirements. Thus far, only one U.S. firm has formed a joint venture, but another is expected to do so in 1995. A number of U.S. securities houses participate in the Jakarta market through their regional offices in Hong Kong and Singapore. Once established as joint-ventures, U.S. securities firms can offer the same securities services as domestic securities firms.

Foreign ownership of shares listed on the Jakarta Stock Exchange is limited to 49 percent of any single issue. The government is considering eliminating the 49 percent rule, but it is not known when a decision will be forthcoming.

DESCRIPTION OF THE MARKET

Stock Exchange

The Indonesian government created the Jakarta Exchange in 1977, and for the next 15 years, a single government agency, Bapepam, operated the exchange and regulated securities trading. Eight hundred people now crowd the trading floor, trading 15 to 20 million shares a day with a value of about $37 million. As of December 1993, the exchange listed 172 companies with a total capitalization of $33 billion.

Foreign investors could not own Indonesian shares initially, nor could foreign companies list their shares on the exchange (nor may they list their shares on the exchange today). In 1987, Indonesia opened the market to foreign investors, but the government limited foreign ownership to 49 percent of the listed shares of any company. (Foreign investment has reached this limit in 32 of the 172 companies listed on the exchange.) In 1992, the exchange

was privatized, and Bapepam became solely a regulatory body similar to the U.S. Securities and Exchange Commission.

There also is an exchange in Surabaya, and a small over-the-counter market in Jakarta.

Equity Markets

The growth of the equity market since the 1987 reforms is reflected in the ratio of market capitalization to outstanding bank loans. In 1988, this ratio was just one-third of 1 percent. By year-end 1993 it stood at 46 percent, and it is expected to rise further.

Twenty new companies offered shares to the public in 1993. In total, the stock and corporate bond markets supplied about $2.2 billion in new financing in 1993. But at just 23 percent of Indonesian GDP, the market is still in an early stage of development.

Trading on the exchange is relatively thin with roughly 1,500 transactions a day, and 60 to 70 percent of the trading is concentrated in the shares of only 30 companies. Many companies elect to sell only a small percentage of their shares. The remaining shares are held privately by the founders of the company.

High transaction costs are one factor constraining greater growth in trading volume. However, transactions costs should come down when the exchange is computerized in late 1994. The current technology is outdated: trades are entered by hand on white boards surrounding the trading floor and, until recently, were cleared broker-to-broker. A clearing corporation, which nets trades, only recently began to operate.

Despite these limitations, and those mentioned above with respect to ownership ceilings, foreign investors participate in at least 80 percent of all trades on the JSE. Foreign buyers are primarily large mutual funds and pension funds rather than foreign individuals. About a third of foreign investors are American, a third European, and a third from the Asia-Pacific region.

Privatization of state-owned enterprises could lead to further growth of the exchange. If the government privatizes 10 to 20 of the major state-owned companies, market capitalization could increase by five- or tenfold. Candidates for privatization include: Indosat, the international long distance company, which plans to list its shares on both the Jakarta and New York Stock Exchanges in 1994; Telkom (the domestic phone company); Garuda (the national airline); and parts of PLN, the electric utility.

Debt Markets

The public and private debt markets are relatively underdeveloped. The principal debt instruments are (1) the SBI (Sertifikat Bank Indonesia), a bill issued by the central bank, Bank Indonesia, to allow it to conduct open market operations; and (2) the SPBU (Surat Berharga Pasar Uang), a corporate promissory note endorsed by commercial banks. At the end of 1993, there were about $11.2 billion in SBIs and about $668 million in SBPUs outstanding.

About $1 billion in commercial paper is outstanding, 10 times the amount of just two years ago. Most issues of commercial paper carry a maturity of 60 to 90 days. Rates are generally about two percentage points lower than bank lending rates and several percentage points higher than rates paid to depositors. Issuers are mainly large corporations, including a few state-owned enterprises. Buyers include major corporations, financial institutions, and foreign investors. Bank Indonesia is encouraging the development of the market by establishing a credit-rating agency and developing a regulatory framework.

The private sector bond market is in its first stage of development. In 1993, Indonesian companies issued about $220 million in bonds in the Jakarta market. Despite an absence of regulatory impediments, bonds are not traded on the exchange, although reports of trades in an over-the-counter market appear in the financial press. (The bonds are bearer bonds, and can easily be traded off the exchange.) One problem in developing a secondary bond market is the lack of a trading culture: purchasers, mainly state-owned pension funds, prefer to operate on a buy and hold strategy.

There are no restrictions on foreigners' ownership of debt instruments. Nor are there any restrictions on foreign joint venture securities firms underwriting fixed-income debt issues. At the moment, however, there are not many issues due to the lack of a good benchmark for long-term interest rates.

Mutual Funds

Domestic investment funds (mutual funds) are a new development to the Indonesian capital market. An investment fund must be managed by an investment manager, which in Indonesia is a limited liability company authorized to manage fund or stock portfolios for clients and to provide investment advisory services.

Growth of the mutual fund industry will be critical to establishing an institutional investor base that can support broader development of the capital markets. Thus far, growth of the mutual fund industry has been hampered by a provision in company law that prohibits a corporation from purchasing its own shares, thus effectively banning open-end funds.

Foreign securities firms and foreign banks may obtain, in conjunction with an Indonesian partner, an investment manager's license.

Venture Capital

Although the 1988 deregulation authorized venture capital firms, only a few venture capital firms are operating, among them a joint venture formed by the International Finance Corporation, Prudential Asia, and an Indonesian bank. Until June 1994, the principal impediment was uncertainty over the nature of implementing regulations to be issued by the Ministry of Finance. In June 1994, regulations were issued that provide tax-free treatment to the capital gains earned by venture capital firms when they sell their investments. Now that the regulations are issued, more firms should enter the market.

Jakarta Stock Exchange Statistical Highlights

	1991	1992	1993
Number of Listed Companies	139	153	172*
Composite Stock Price Index	247	274	589
New Issuers	16	14	20
Market Capitalization ($ Billion)	8.4	12.2	33.2
Trading Volume (Million Shares)	1,008	1,706	3,844
Trading Value ($ Billion)	3.0	3.9	9.1
Average Daily Trading Volume (Million Shares)	4.1	6.9	15.6
Average Daily Trading Value ($ Million)	12.1	15.9	37.1
Number of Listed Shares (Million Shares)	3,729	6,254	9,787

* One company was delisted in 1993
Source: Jakarta Stock Exchange 1993 Annual Report

Residents' Access to Overseas Markets

Residents may freely access financial instruments offshore as investors. In addition, Indonesian residents may freely access offshore markets as issuers of securities or notes. U.S. firms have participated in underwriting these issues. For example, in July 1994, Merrill Lynch managed the initial public offering of the Indonesian firm Tripolyta on the NASDAQ; in late 1994, it will act as the lead underwriter in the listing of Indosat, the state-owned telecommunications company, on the New York Stock Exchange.

However, the government does restrict foreign borrowing from commercial sources. In order to manage the growth of the country's foreign debt, annual ceilings are set on all commercial borrowing except trade financing.

U.S. PRESENCE IN THE MARKET

Until 1988, a single state-owned firm, P.T. Danareksa, was the leading provider of underwriting and brokerage services in Indonesia. The 1987 financial reforms allowed foreign firms (both foreign banks and foreign securities firms) to form joint venture securities firms in Indonesia to underwrite, broker, and deal in securities. In addition, foreign banks and foreign securities firms can act as investment managers.

While 29 joint ventures securities firms are active members of the JSE, so far only one American firm — Bankers Trust — has formed a joint venture. It has chosen to concentrate on financing, underwriting, and brokerage activities. Merrill Lynch expects to form a joint venture in 1995. Morgan Stanley has an equity participation with PT Makindo, the largest domestic broker through an associated investment management firm.

Other major U.S. brokerage houses participate in the Jakarta market through their regional offices based in Hong Kong and Singapore.

The three largest custodians operating in the market are foreign banks. Citibank plays a very significant role in this market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Indonesia took a significant step in opening up its capital markets to foreign firms in 1988, when it authorized foreign firms to act as broker-dealers, investment managers, and underwriters in partnership with Indonesian firms. However, Indonesia has made no progress to expand market access in the years since. Entry must be via a joint venture. Branches are not permitted.

American securities firms face two impediments to entry. First, American (and other foreign) firms must have a local joint venture partner with at least a 15 percent Indonesian ownership interest. Many U.S. firms feel that potential local partners do not bring sufficient expertise or customer relationships to the venture to justify a 15 percent share in a firm.

Second, Indonesia subjects U.S. firms to discriminatory capital requirements. The minimum paid-up capital requirements for local and foreign joint ventures are as follows:

Type of License	Domestic Firm
Broker-Dealer	500 Million Rupiah ($234 Thousand)
Underwriter/Broker-Dealer	5 Billion Rupiah ($2.3 Million)
Investment Manager	500 Million Rupiah ($234 Thousand)
	Foreign Joint Venture
Broker-Dealer	1 Billion Rupiah ($468 Thousand)
Underwriter/Broker-Dealer	10 Billion Rupiah ($4.6 Million)
Investment Manager	1 Billion Rupiah ($468 Thousand)

The authorities present different rationales for the joint venture requirement and the discriminatory capital requirements. The joint venture requirement purports to encourage the development of local expertise and ownership. The discriminatory capital rules are a simple barrier to entry designed to permit domestic securities firms to develop without full foreign competition. Bapepam is reportedly considering the elimination of the discriminatory capital requirements.

The rules have the effect of impeding foreign access. Only a single American securities firm has opened an office in Jakarta. Moreover, the rules have created less local expertise than Indonesia had been hoping for: citizens of Hong Kong and Singapore, not citizens of Indonesia, are employed by some of the major American securities houses active in Indonesian capital markets.

Once established, foreign firms can offer the same securities broking and underwriting services as domestic firms. However, there are relatively tight limits on the number of foreign personnel that can be employed in Indonesia. These apply not only to securities firms, but also to other foreign companies doing business in Indonesia.

Foreign banks and foreign securities firms are allowed to engage in fund management activities and are treated in the same way as domestic banks and domestic securities firms. Investment managers that manage mutual funds must be licensed by Bapepam, the Indonesian equivalent of the SEC. Management of pension fund assets can be delegated to a financial institution approved by the Ministry of Finance. The financial institution must be either a licensed investment manager or a commercial bank. Both the mutual fund and the pension fund management industries are in their infancy.

The rules governing banks and securities firms are published by the regulatory authorities, and foreign financial institutions are aware of the rules. In 1993, formal notice and comment procedures were initiated with respect to rule-making.

Exchange Rates

Average 1993:	$1 = 2,087.1 rupiah
End of year 1993:	$1 = 2,110.0 rupiah

JAPAN

BANKING

SUMMARY

Japan generally provides de jure national treatment for foreign banks, and in a few isolated instances, has provided better than national treatment.

Nonetheless, foreign banks remain only marginal players in the Japanese banking market. This is partly a reflection of Japan's regulatory environment and partly the consequence of exclusionary business practices. Strong relationships between members of related business groups, often involving cross-shareholding arrangements, make it extremely difficult for nonmembers (i.e., foreign banks) to effectively compete in the Japanese banking market.

As of year-end 1993, 19 U.S. banks in Japan operated 41 branches with assets of $18.3 billion and 15 subsidiaries with assets of $2.3 billion. Among these subsidiaries are six trust companies and four leasing companies. Ten U.S. banks also maintain representative offices in Japan. In contrast, U.S. banks operated 31 branches with assets of $16.6 billion and 21 subsidiaries with assets of $2.2 billion in Japan as of year-end 1989.

At the end of 1993, 54 Japanese banks in the U.S. operated 48 agencies with assets of $49.0 billion, 84 branches with assets of $272.1 billion, and 26 subsidiaries with assets of $63.0 billion. Japanese banks or individuals controlled four Edge Corporations with assets of $188.5 million. Japanese banks maintain 54 representative offices in the United States. Excluding Edge Corporations and the New York State Investment Corporation, this presence represents a net increase of 32 operating offices, but a decrease of $36.4 billion in assets since year-end 1989. At that time, 41 Japanese banks were operating in the United States, through 25 subsidiaries, 66 branches, 35 agencies, and 88 representative offices. There were five Edge Corporations and one New York State Investment Corporation. Their total assets were $672.7 billion.

DESCRIPTION OF THE MARKET

Domestic Banking Market

The structure of the Japanese banking market remains the same as reported in earlier national treatment studies, at least in terms of continuing the demarcation of certain types of banking business among city banks, long-term credit banks, trust banks, regional banks, and various specialized institutions. However, there have been some notable and helpful changes since the last report that in some cases relax, and in other cases eliminate altogether, important

banking restrictions impeding competition. These are discussed below in the section Regulatory Changes Since 1990.

City Banks

The largest Japanese banks are the 11 "city banks," which are similar to American money center banks. They had total assets in 1993 of $2.93 trillion and a total market share of 35 percent. In 1990, two of these city banks merged to form the second largest bank in the world; in 1991, two relatively small city banks merged to form the ninth largest city bank in Japan.

City banks have nationwide branch networks. They generally make short-term loans and fund their activities primarily through consumer and business deposits and short-term money market instruments (e.g., certificates of deposit, money market certifcates, call money, bill discounts, etc.). City banks tend to have a stable commercial customer base, frequently involving share ownership with their most significant commercial clients.

Lending by city banks has slowed dramatically since 1991. Loans outstanding by city banks increased only 2.2 percent in 1992, and only 0.4 percent in 1993. The main reasons for the lending slowdown were weak growth in domestic economic activity and heightened precautions among the banks over customer creditworthiness amid an increasing level of nonperforming loans.

Long-Term Credit Banks

Long-term credit banks, of which there are three, were created decades ago to provide long-term loans to private industry. Unlike city banks, the liabilities of long-term credit banks are primarily medium-term bank debentures with maturities of up to five years. Long-term loans make up the majority of their assets, although long-term credit banks also are active in bond markets as investors, underwriters, and as "commissioned banks" in the issuance of corporate debt instruments. Assets outstanding of the three long-term credit banks totalled $676 billion in 1993. Their market share in 1993 was 8 percent.

Trust Banks

There are 24 trust banks in Japan, with total assets in 1993 of $2.4 trillion. Eight of these banks may be classified as "old Japanese faces," including one Japanese city bank that was "exceptionally" grandfathered to do trust business concurrently with its "city bank" business. Nine are foreign trust bank subsidiaries established in the mid-1980s. Seven are "new Japanese faces" established pursuant to the April 1993 Financial System Reform Act (see below). In addition, 16 regional banks have been licensed to do certain trust banking

business directly, without establishing separate subsidiaries (two regional banks in Okinawa had been engaging in trust business prior to 1993).

The eight "old Japanese faces," and the nine foreign trust bank subsidiaries established in the mid-1980s, are permitted to engage in a full range of trust banking business. The 23 "new Japanese faces," (inclusive of the regional banks doing trust business) are restricted to a narrower range of non-core trust business only. The latter are prohibited from managing pension funds.

Business circumstances surrounding trust banks have changed dramatically within the last five years. During the latter part of the 1980s, trust banks experienced the most rapid growth of any of the Japanese banking sectors, thanks to the special niche set aside for them — "tokkin" funds/fund trusts, medium-term portfolio investments that offer tax advantages for corporate clients — and their exclusive right among banks to manage pension fund assets. However, beginning in 1990, their business fortunes were reversed as a result of the steep fall in Japanese asset prices and the subsequent economic recession that put many of their loans in jeopardy. Trust banks are the most heavily exposed among the banks to bad loans, and their earnings have suffered the steepest fall due to heavy loan writeoffs and poor operating profits. Among the various types of banks, trust banks have the highest capital adequacy ratios.

Regional Banks

There are 129 regional banks in Japan — 64 so-called "first-tier" regional banks, of which some are quite large, and 65 so-called "second-tier" banks. The number of regional banks increased significantly in 1989 with the conversion of 66 sogo, or mutual savings and loan institutions, into second-tier regional banks. This action more than doubled the total number of regional banks. Since the last national treatment report, one second-tier regional bank was merged into a first-tier regional bank in 1993, bringing the number of second-tier banks to 65 as of April 1, 1994. Altogether, regional banks had $2.3 trillion in total assets at the end of 1993 and a combined market share of 28 percent.

Regional banks traditionally have relied on savings deposits from individuals to fund their activities. Their assets are concentrated in loans, particularly to small businesses, but their asset base also includes some domestic securities and some foreign assets.

Specialized Institutions

In addition, there are other specialized institutions involved in banking activities. The Norinchukin bank is owned by agricultural cooperatives and acts as their central bank. Agricultural financial institutions have significant bad loan exposure, particularly to specialized housing lenders (Jusen). Norinchukin bank is the single largest lender to Jusen,

whereas agricultural financial institutions as a whole have been the lenders of about 40 percent of all Jusen borrowing. Agricultural financial institutions increased their real estate lending aggressively during the very last stage of the asset-inflated economy in the early 1990s, following constraints imposed by the Finance Minitstry that to restrain commercial banks' growth in real estate lending to no more than their growth in total lending. In 1993, the agricultural financial institutions agreed, albeit reluctantly, to share in the burden of bailing out the Jusen through interest forgiveness. Nearly 60 percent of the 13 trillion yen in Jusen assets are believed to be nonperforming.

An extremely important element in the overall deposit-taking system in Japan is the postal savings system, which competes with conventional banking institutions for small-saver personal deposits. By law, these funds must then be transferred to the Finance Ministry's Trust Fund Bureau, which then manages the funds either by directing investing in money market instruments and public securities, or by reallocating the funds to the Fiscal Investment and Loan Program where the funds are used for public investment projects or on-lent through public sector financial institutions. As of year-end 1993, the postal savings system had collected deposits totalling 180 trillion yen. Lending by FILP-related public sector financial institutions accounted for virtually all new lending growth in 1993 and 16.6 percent of all loans outstanding.

Under the Japanese system, only "authorized foreign exchange banks" can do a full range of foreign exchange business. However, licenses are available to all commercial banking institutions that can demonstrate some expertise in the area. Currently, there are 343 such banks, including all 11 city banks, all 64 first-tier regional banks, all 3 long-term credit banks, 13 Japanese trust banks, and all foreign banks. Most second-tier regional institutions, Norinchukin, and some credit cooperatives, and credit associations also have foreign exchange licenses.

The following table summarizes assets held by the various kinds of banks in Japan:

Assets of Banks in Japan by Type of Bank

Japanese Banks:	Number	Total (billions of yen)
City Banks	11	327,533
Long-Term Credit Banks	3	75,604
Trust Banks	7	245,659
First-Tier Regional Banks	64	187,776
Second-Tier Regional Banks (Former Mutual S&L Banks)	65	69,953
Credit Associations	428	105,473
Credit Cooperatives	381	28,956
Labor Credit Associations	47	9,807
Agricultural Cooperatives	2,727	50,186 [1]
Central Cooperative Bank for Agriculture and Forestry	1	46,866
Foreign Banks:		
Commercial Banks	90	26,445 [2]
— of which U.S.	(20)	(3,978) [2]
Trust Banks	9	5,860 [2]
— of which U.S.	(6)	(3,490) [2]

[1] End-March 1992 figure
[2] End-March 1993 figure..

Notes: The number of banks is as of April 1, 1994, for Japanese banks and as of year-end 1993 for foreign banks. Total assets are as of year-end 1993, unless otherwise indicated. In addition to the institutions in the table above, there are seven trust bank subsidiaries of Japanese financial institutions established under the April 1993 Financial System Reform Act. Parent financial institutions are four securities houses, one city bank, one long-term credit bank, and one umbrella organization of credit associations. Asset data of these subsidiaries are not available.

Deteriorating Loan Portfolios

The most serious challenge to the health of the Japanese financial system in the first half of the 1990s has been the growing problem of nonperforming loans. Most lending in Japan is secured, usually by real estate or loans with third-party guarantees. As long as the pledged collateral held its value and the economy stayed robust, the danger of defaults and of losses accruing from defaults was minimized. But as asset prices plummeted from their peak values in 1989/90, and the growth of the Japanese economy underwent a marked slowdown, Japanese banks across the board have faced a serious problem in managing their increasing exposure to nonperforming loans.

Inadequate disclosure requirements have made it difficult to fully evaluate the severity of the bad-loan problem plaguing Japan's banking industry. No data are available on the total value of problem loans. Certain large banks began disclosing data on their problem loans beginning with the fiscal year ending March 1993, but the disclosure was limited to only part of the problem loans. The top 21 banks announced that their combined nonperforming loans continued to grow through March 1994, albeit less steeply than in 1993, as problem loans of the top 21 reached 13.6 trillion yen at the end of March 1994. This figure accounted for about 4 percent of these banks' total lending outstanding, but individually the degree of bad-loan exposure varied from between 2 percent and 7 percent. Smaller banks have not been required to disclose their bad loans (except for bankrupt borrwers' loans), but some private estimates put the figure of their bad loans at a little more than one-half of those of the top 21 banks, although a few estimates range even higher. The data on problem loans are further complicated by the fact that restructured loans are not included in the disclosed totals, nor are bad loans included in the total if a lender has made an additional loan to cover interest in arrears. Japan's definition of a problem loan is more liberal than that of the United States; problem loans are defined as those loans on which interest in arrears totals six months or more, and loans of bankrupt borrowers.

The Japanese government has been busy trying to help banks reduce their bad loan exposure, in the hope of bolstering confidence in Japan's financial system and support the stock market by promoting stronger bank balance sheets to alleviate market concerns over bank lending constraints. These efforts include the establishment of a "lifeboat" institution, the Cooperative Credit Purchasing Corporation (CCPC), in January 1993, which would enable banks to capture tax-expensable charge-offs by selling nonperforming loans to the CCPC. Other efforts include more relaxed rules on the securitization and sale of loans. In February 1994, Ministry of Finance issued policy guidelines on bank nonperforming loans, including creation of a new mechanism to transfer restructured loans off bank's balance sheets to new Special Purpose Companies (SPCS), also for tax-expensable charge-offs.

Japanese banks have been aggressively writing off problem loans. The top 21 banks wrote off 4.1 trillion yen in the business year ending March 1994, more than double the total of

a year earlier, and more than five times the total of two years earlier. Nonetheless, total write-offs represent only 20 percent of total disclosed bad loans.

The monetary authorities have shown no sign of wavering from their "no failures" policy, and they continue the practice of finding merger partners for ailing banks. This is partly because the Japanese deposit insurance system is poorly funded, with resources of only 771 billion yen, an amount equivalent to just 0.1 percent of total bank deposits.

Regulatory Framework

Under the Banking Law, banking business is reserved for banks. The Foreign Exchange and Trade Control Law prohibits, in principle, financial firms other than banks from engaging in foreign exchange business. The April 1993 Financial System Reform Act permits Japanese securities firms to engage in banking business, including a limited range of trust banking business and a broader range of foreign exchange business through separate subsidiaries.

Supervision and regulation of the banking industry is carried out by multiple administrators, (i.e., Ministry of Finance, the Bank of Japan, and the industry's self-regulatory organizations). The Finance Ministry has exclusive authority for licensing banks, and it retains broad responsibility for regulating and supervising commercial banks, trust banks, smaller banking institutions, life and nonlife insurance companies, and consumer finance companies, both Japanese and foreign, as well as the Tokyo International Financial Futures Exchange (TIFFE). Within the Ministry of Finance, the Banking Bureau is responsible for banking policy, licensing, supervision, and regulation, and the International Finance Bureau is responsible for licensing and regulating foreign exchange business and cross-border banking activities. With Finance Ministry oversight, self-regulatory functions are carried out by the TIFFE, the Federation of Bankers Associations, and by other bank-related self-regulatory groups. The Bank of Japan supervises banks based on contractual agreements with individual banks. The statutory responsibility for monetary policy rests with the Bank of Japan.

REGULATORY CHANGES SINCE 1990

Several steps have been taken since the 1990 National Treatment Study to further relax regulations in the banking sector. Most of these steps represent extensions of liberalization measures taken in earlier years. A few, however, represent a change in regulatory approach.

Financial System Reform

Potentially the most far-reaching step taken was implementation of the Financial System Reform Act (FSRA) in April 1993. The FSRA reversed Japan's 40-year postwar practice of prohibiting entry by banks into the securities business and securities firms into the banking business by allowing cross-over entry, in principle, through separate subsidiaries. The act was the culmination of eight years of debate and study.

In implementing the new law, the Finance Ministry has staggered entry (i.e., long-term credit banks were allowed to enter the securities business before city banks were allowed to establish securities subsidiaries). In addition, the Finance Ministry has restricted the range of eligible business of the subsidiaries by preserving certain core business activities exclusively for pre-FSRA licensed intermediaries. For example, new trust banking subsidiaries may not engage in the management of pension funds or tokkin business, and securities subsidiaries of banks may not broker or underwrite equities. Thus, Japanese brokerage houses face no new challengers to their retail brokerage business, and Japanese trust banks and life insurers face no new challengers to their management of pension funds.

In addition, physical and operational "firewalls" were created to limit the expansion of bank powers. New subsidiaries must be separately capitalized, effectively limiting new entrants, at least initially, to only the largest banks and largest securities houses. No sharing is permitted of board members or auditors; restrictions also exist on the sharing of employees, computer systems, and office spaces. No tie-in sales or trading on favorable terms is permitted. Securities subsidiaries of lead commissioned banks are prohibited from lead-managing corporate bond issues except for certain large corporate issues. And there are limits on the weight of business between a parent and a subsidiary. (According to MOF, these restrictions and firewalls are to be reviewed within 2 to 3 years after the enactment of the FSRA.)

Thus, at least for the time being, the Japanese banking market continues to be characterized by compartmentalization, in which the scope of business activities for individual types of financial institutions remain limited. These changes had been opened up earlier to the foreign financial community ahead of the domestic institutions, so to some extent foreign firms lost the relative advantage they enjoyed of being able to offer, at least in principle, a cross-section of financial services. Still, an element of "better than national treatment" remains because affiliates of foreign firms were "grandfathered" to engage in certain activities yet to be permitted Japanese subsidiaries.

Interest Rate Deregulation

All remaining restrictions limiting the rates of interest that banks may pay their depositors on "time deposits" were removed in June 1993, and in October 1994, the last remaining restrictions on "non-time deposit" interest rates were lifted. With the exception of "current deposits," which account for about 5 percent of total bank deposits, all bank deposits in

Japan now carry market-determined rates of interest, thus completing the 15-year process of interest rate deregulation.

Discount Window Access

In April 1991, the Bank of Japan (BOJ) revised its criteria for setting maximum limits on "ordinary loans" by the Bank of Japan to major city banks. The BOJ's aggregate credit line to all nine city banks remains unchanged at 5 trillion yen, an amount equivalent to 1.6 percent of their yen loans outstanding. For foreign banks, BOJ "ordinary loans" are set at 2.6 percent of their domestic yen loans outstanding.

Money Markets

Several improvements have been made to enhance the operation of the money markets. In November 1990, a bid/offer system was introduced in the collateralized call money market, which, unlike earlier years, now permits lenders and borrowers to negotiate lending rates with or without the intermediation services of "tanshi" companies (money brokers). In November 1991, postdated transactions in the unsecured call money market were introduced to improve arbitrage opportunities with the Euro-yen market. In July 1992, postdated transactions in the bill discount market were introduced. And in August 1993, a Japanese-British joint venture foreign exchange broker was allowed to enter call money brokerage activities, the first new entry into the money brokerage business in three decades. Outstanding volume in the call money market has increased by about 60 percent since 1990. However, outstanding volume in the bill discount market has shrunk by 40 percent since 1990.

Commercial Paper

Regulations governing maturities, tax treatment, and authority to issue commercial paper (CP) have been gradually liberalized. Following the initial launching of domestic yen CP in November 1987, the commercial paper market grew to 16 trillion yen in 1990. However, by year-end 1993 the market had shrunk to 11 trillion yen. Economic conditions were a major factor.

Both banks and securities firms may act as arrangers in the market, but Japanese banks dominate the market. The 11 city banks alone arranged one-half of the new commercial paper issued in 1993, bringing the combined share of commercial paper arranged by all Japanese banks to 77.6 percent. Securities firms arranged the remaining 21 percent, and foreign banks arranged 1.4 percent. No direct issue of commercial paper by borrowers is permitted.

The Finance Ministry has lowered the minimum rating threshold required to issue CP, presently A2, the second highest rating possible. Theoretically, this has expanded the number of potential issuers to an estimated 550, but, in practice, as of year-end 1992 only 240 of the 2,118 listed firms had obtained the necessary rating. In June 1993, the Finance Ministry permitted nonbanks to issue commercial paper, but only on a limited basis and subject to the very significant restriction that nonbanks not use the proceeds from commercial paper issued for lending purposes. In April 1994, the ministry permitted insurance companies to issue commercial paper under similiar conditions. During 1994, the Finance Ministry began permitting issues of overseas asset-backed Euro-yen bonds, but as of this writing, the ministry continues to prohibit the issuance of the same in Japan.

Netting

In December 1993, the Finance Ministry confirmed that Japanese banks might enter into "close-out" netting agreements. In March 1994, the Bank of Tokyo became the first Japanese bank to enter into a foreign exchange netting agreement with a U.S. bank.

Asset/Capital Positions of Banks

Japanese banks have steadily improved their risk-weighted asset/capital positions since 1990. The improvement was the product of a combination of bank efforts to control asset growth and steps taken by the Ministry of Finance to facilitate the ability of banks to raise capital and shed assets in advance of the March 1993 Bank of Internation Settlements requirement that capital equal 8 percent of risk-weighted assets.

For the purpose of enhancing the capital base, the Finance Ministry permitted subordinated term debentures and loans for the first time in the summer of 1990. In 1991, the ministry expanded exceptions to the moratorium on new equity financing and permitted a few selected banks to issue new equity. In March 1992, the ministry allowed Japanese banks to issue preferred stock, initially limited to offshore markets only. In mid-1992, the first Japanese bank compulsory convertible bond issue was launched. In August 1992, with stock prices and the value of unrealized equity assets at a six-year low, the ministry began permitting perpetual subordinated bonds and loans because issues of subordinated term debts were nearing their upper limits. And in March 1994, the first domestic preferred stock issue by a Japanese bank was launched.

The Finance Ministry also expedited loan securitization by expanding the pool of eligible investors to include corporate pension funds to help banks shed assets. The ministry also dropped its requirement that lenders first gain the consent of corporate borrowers before proceeding with the sale of a business loan made to that borrower. In addition, the ministry lowered the risk weight for local government debt from the previous 10 percent to zero. And at the end of 1993, the ministry confirmed that Japanese banks might engage in forex

netting deals, initially with U.S. counterparties only (Europeans later), thus enabling Japanese and U.S. banks to net out off-balance-sheet risk-weighted assets against off-balance sheet liabilities. Yen appreciation over the period also supported improvement in the capital adequacy ratios.

Financial Futures Market

Trading in the Tokyo International Financial Futures Exchange (TIFFE) ballooned sharply in 1993 after spending most of the 1990-92 period in the doldrums. Annual turnover jumped over 60 percent in 1993, led by bullish trading of short-term yen interest rate futures, which alone accounted for 98 percent of total turnover.

Membership in TIFFE, however, has declined nearly 20 percent over the last five years to 216 members as of April 1994. Membership by foreign securities firms increased from eight at the start of TIFFE in June 1989 to 12 as of April 1994, of which eight are clearing members and nine are American securities houses. Membership by foreign banks declined from 12 to 8, with one acting as a clearing member as of April 1994. Only one U.S. bank is now a member of TIFFE, down from four in 1989.

Basic capital requirements are very high. Initially, TIFFE had reduced the amount of capital required of foreign members to assure a significant degree of participation, but the favor was soon abrogated.

TIFFE was established mid-1989, specializing in bank-related financial futures and options products, initially with three product lines — futures on three-month Euro-yen and Euro-dollar interest rates and the yen/dollar exchange rate. Since then, two additional products have been added: one-year Euro-yen interest rate futures and options on Euro-yen interest rate futures. In addition, effective October 1994, FRAs and FXAs were permitted.

U.S. PRESENCE IN THE MARKET

There are 90 foreign commercial banks in Japan, of which 20 are American-owned. All are branches. Most of the growth in the foreign bank presence in Japan occurred in the 1970s and 1980s. At the end of 1970, there were only 18 foreign banks in Japan, with a total of 38 branches. These numbers grew to 64 and 86, respectively, by 1980, and to 82 and 122, respectively, by 1990. As of year-end 1993, there were a total of 145 foreign bank branches. Of this latter total, U.S. banks operated 44 branches.

Despite the numerical increase, foreign banks, including those from the United States, are, at best, only minor partcipants in the Japanese banking scene. Total lending by foreign banks rose from 1.6 percent of the market in 1989 to 2.5 percent by year-end 1990. The increase was largely attributable to additional lending by non-U.S. banks filling the vacuum

created by restrictions imposed at that time on Japanese banks by the BOJ and MOF to curtail real estate lending. When those restrictions were lifted in 1991, the ratio of foreign bank lending to total lending declined once again to 1.7 percent by year-end 1993. (No data are available for U.S. bank lending.) For U.S. banks, their relative inactivity in domestic lending activity is largely voluntary — the result of economic decisions based on interest rate margins available in Japan and decisions about the global allocation of their capital.

In 1985, the trust banking market was opened to a fixed number of foreign financial institutions. Nine were permitted to enter the market (one more than the number of Japanese banks doing a full range of trust business). Of the nine, six are U.S. trust banks. All are subsidiaries. After an initially spotty start in which some foreign trust banks did quite well but others did not, the combined earnings of the nine foreign trust banks have deteriorated rapidly. In the Japanese fiscal year ending March 1993, the nine foreign trust banks posted combined pre-tax losses of 1.1 billion yen ($10.0 million). This follows a 1.6 billion yen ($12.8 million) net loss the preceding fiscal year. Two of the six U.S. trust banks showed pre-tax losses. Foreign trust banks have had some success in making an inroad into the discretionary "fund trust" market, where their share of the market climbed from 7.8 percent in 1989 to 12.5 percent by March 1993. They have made very little headway in the area of pension fund management, where their market share edged up only marginally from 0.17 percent in 1989 to 1.0 percent in 1993, roughly nine years after they first entered the market.

A number of foreign banking entities have been allowed to enter the domestic securities market through branches of offshore securities subsidiaries, provided their equity stake in their branch is no more than 50 percent. Thus far, 28 such securities branches have been established, eight of which have U.S. parents. And beginning in 1991, several securities firms were authorized banking licenses, primarily to conduct foreign exchange operations. As of April 1994, four such banking licenses had been authorized. All four belong to offshore banking subsidiaries of U.S. securities firms.

In addition, there are 112 representative offices of foreign banking institutions in Japan (of which 10 have U.S. parents). This compares to 131 in 1989 and 71 in 1974. These offices are limited primarily to observing the market and to reporting on developments to their home office. They are not allowed to take deposits or to make loans. Most banking institutions establish a representative office prior to applying for a bank branch license.

As for the acquisition of a Japanese bank by a foreign bank (including by a U.S. bank), no acquisition has occurred as of this report, but neither have any U.S. financial institutions expressed an interest in acquiring a Japanese bank. However, the Finance Ministry continues to assure the U.S. Treasury Department that acquisition is possible and that the ministry would approve such a purchase, if and when an interest is expressed.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Management of Pension Funds

As noted above, after nearly 10 years in the market, U.S. trust banks have been unable to do more than scratch the surface of the $1 trillion public and private pension fund market in Japan. Unlike investment advisory companies (see the chapter on Securities Markets in Japan), foreign trust bank subsidiaries face no direct legal obstacle to competing for pension fund management mandates. In fact, foreign trust banks are among the select few (Japanese life insurers and the eight "old face" Japanese trust banks being the others) who may compete for management mandates in both the private and public pension fund sectors. Legal access aside, success in attracting pension assets has thus far eluded U.S. trust banks. Foreign trust banks in Japan, in total, manage only 1.7 percent of public pension funds, and just 0.3 percent of private pension funds. By contrast, in the United States, foreign financial institutions manage 11.5 percent of U.S. pension assets — of which Japanese financial institutions manage 4.8 percent.

The principal obstacle facing U.S. and foreign trust banks in Japan in gaining a greater share of the pension fund management market is the practice of management mandates being awarded to fund managers on the basis of corporate relationships rather than on the basis of economic performance. Often these relationships involve some degree of cross shareholding.

Accordingly, U.S. trust banks have sought — without success thus far — to encourage the Japanese government (specifically the Finance Ministry) to strengthen the fiduciary responsibilities of pension plan sponsors in order to encourage sponsors to pay greater attention to performance, to eliminate the asset allocation guidelines that force all fund managers to invest in a "balanced portfolio" rather than in assets or currencies where they have greatest expertise, to adopt standardized performance evaluation criteria along the lines of those of the U.S. Association for Investment Management and Research (AIMR), and to value pension fund assets at current market value rather than at book value. U.S. trust banks believe that if these changes were adopted, pension fund plan sponsors would be in a better position to accurately assess the relative performance of fund managers, including the performance of foreign trust banks.

It is worth noting that various advisory groups to the Ministry of Finance have recommended similar changes, as too have the Pension Fund Association of Japan and the Ministry of Health and Welfare, which shares with the Finance Ministry the responsibility for overseeing the pension fund system in Japan. As of this writing, the Finance Ministry has opposed making these regulatory changes.

Accounting and Disclosure

U.S. banks have complained that weaknesses in Japan's approach to accounting and disclosure of information by financial intermediaries (and nonfinancial corporations) give a very distorted picture of counterparty risk, the financial well-being of Japanese banks, and credit evaluation of prospective borrowers. Insufficient disclosure, as noted above with respect to nonperforming loan portfolios, also clouds the picture.

Lack of Transparency

A chronic complaint of U.S. financial institutions operating in Japan is the lack of transparency in the Japan's regulatory environment. This has been a longstanding problem that unnecessarily complicates the ability of foreign (and U.S.) banks to do business in Japan. These complaints persist even though the Finance Ministry has taken steps in recent years to improve communications and increase its frequency of contact with U.S. banks.

Issuance and Use of Commercial Paper

Potential issuers of commercial paper view the rating, listing, and disclosure requirements as too severe. Nonbanks dislike being prohibited from using the proceeds from the issuance of commercial paper for lending purposes.

TREASURY-MOF FINANCIAL MARKET NEGOTIATIONS

In the mid-1980s, following the Yen-Dollar Agreement between the U.S. Treasury Department and the Japanese Finance Ministray, many of the issues on the bilateral agenda focused on bank-related areas of interest (i.e., development of a deeper and more liquid money market, deposit rate deregulation, access to the public bond underwriting market, securities licenses for banks, and the introduction of certain derivatives products, including forward rate agreements). While most of the major banking issues have been resolved, at least with respect to the ability of foreign banks to obtain market access "in principle," most U.S. banks still feel that the business climate in Japan could be greatly improved if the regulatory environment were made more transparent, and if modern accounting and disclosure practices were adopted throughout all industries.

In the context of the ongoing financial market negotiations between the U.S. Treasury and Japanese Finance Ministry under the U.S.-Japan Framework for a New Economic Partnership, Treasury is pursuing several changes with practical benefit for foreign banks, including improvements in the pension fund market for U.S. trust banks, relaxed issuance criteria for commercial paper, and greater transparency.

JAPAN

SECURITIES

SUMMARY

The Japanese financial system continues to be subject to tight regulation and supervision by the Ministry of Finance (MOF). Over the past decade, MOF has implemented a number of measures to liberalize and deregulate some areas of the financial markets, including the securities market. The government of Japan today formally espouses a policy of national treatment in its regulation of the financial system.

However, despite gradual deregulation, foreign securities firms continue to be denied equality of competitive opportunity in the Japanese securities market. This is particularly true in those areas where U.S. securities firms are most competitive and of greatest threat to Japanese financial institutions. Among the many problems, access to the domestic lead underwriting business has been virtually nonexistent. U.S. securities firms have little freedom to innovate and offer new securities products in Japan or to market products in which they have a clear competitive advantage. Japanese investors' direct access to foreign markets and foreign securities products is constrained by law and administrative guidance. Securities firms have been prevented from offering many foreign exchange services central to their business, and in other areas where U.S. securities firms have proven expertise, such as the management of pension funds and investment trusts (i.e., mutual funds), regulations either severely restrict their participation or prohibit them from competing altogether. Transparency of the regulatory system remains inadequate.

DESCRIPTION OF THE MARKET

Domestic Securities Markets

Equity Markets

The market value of the equity of the 2,155 firms listed on the Tokyo, Osaka, Nagoya, and five other Japanese stock exchanges plunged to 335.5 trillion yen ($3 trillion) by year-end 1993, nearly one-half the level at year-end 1989. Aggregate trading volume also fell to 101 billion shares in 1993, down 60 percent from 1989. New equity financing plunged to 823 billion yen ($7.4 billion), less than one-tenth the level of 1989. Equity financing was suspended by the Japanese government in April 1990 because of the sharp downturn in the stock market. The moratorium was gradually eased beginning in the summer of 1990. A full — but cautious — resumption of equity financing did not occur until early 1994, and even then stringent qualification standards remained on certain issuers. During the moratorium, and even after resumption, a number of U.S. securities firms complained about

"extra-legal" interference by the Japanese government with regard to Japanese equity-linked issues offshore.

From a peak of 127 as of end-1991, the number of foreign firms listed on the Tokyo Stock Exchange has fallen to 97, and will fall further to 92 by end-1994. Of the 92, 46 are U.S. firms. There are no foreign firms listed on Japan's other seven exchanges.

In the registered over-the-counter (OTC) market, 1.2 billion shares of 491 companies were traded in 1993. The number of firms and annual turnover in this market approximately doubled from 1989.

At the end of March 1994, major holders of listed shares included nonfinancial corporations (24.4 percent), banks and insurance companies (40.8 percent), securities firms (1.3 percent), investment trusts (3.0 percent), individuals (23.7 percent), foreign investors (6.7 percent), and government entities (less than 1 percent). Foreign and Japanese individual investors have gained relative shares since 1990, while Japanese corporate and institutional investors as well as securities brokers have reduced their relative presence in the market.

Debt Markets

Government securities dominate the debt markets. Total domestic issuance of Japanese government bonds (JGBs) in 1993 amounted to 51 trillion yen ($462 billion). Since October 1990, MOF has sold 60 percent of each monthly issue of 10-year JGBs through a competitive price auction. The remaining 40 percent is underwritten by the straight syndicate method, with the issuing price set at the average of the auction result. Eligible bidders include roughly 830 underwriting syndicate members. U.S. securities firms have complained that MOF should move to a 100 percent auction system, arguing that the 40 percent set aside for the syndicate is MOF's way of satisfying many small underwriters who otherwise might not bid or compete successfully for a share of the primary market.

The corporate securities market has continued to develop in terms of product breadth, ease of issuance, and liquidity of secondary market trading, but it remains very small in comparison to GDP. Domestic corporate bond issuance (including issues by utilities, convertibles, and warrants) in 1993 totaled 5.4 trillion yen ($50 billion), or just 1.2 percent of GDP. (The comparable figure for the United States is about 16 percent.)

By year-end 1993, total bonds outstanding (government and corporate) totalled 354 trillion yen ($3.2 trillion), of which 64.5 percent were central and municipal government bonds and government-guaranteed bonds. Bank debentures accounted for 22.2 percent, corporate straight bonds 5.8 percent, convertible bonds 5.1 percent, warrant bonds 0.4 percent, and foreign-issued yen bonds 2.1 percent. The market for domestic commercial paper of prime

corporations, which was launched in November 1987, was 11 trillion yen ($99 billion) outstanding as of December 1993.

Derivative Markets

In the past four years, the markets for securities derivative products have stagnated across the board. In bond derivatives, most trading centers on 10-year JGB futures, with 1993 volume amounting to 1,516 trillion yen ($13.56 trillion), followed by JGB options on futures at 151 trillion yen ($1.3 trillion) and 20-year JGB futures at 311 billion yen ($2.8 billion). Trading of over-the-counter (OTC) bond options, according to the Ministry of Finance was 175 trillion yen ($1.4 trillion). Trading volume recovered somewhat in 1993, but nevertheless remained about 20 percent below 1989 levels.

Meanwhile, amid the sharp declines in cash stock prices, the government sharply tightened controls on stock-index derivative trading beginning in mid-1990, ratcheting up the controls on several occasions over the next several years, to address cash-derivatives according to MOF. As a result, trading volume in Nikkei 225 futures, listed on the Osaka Stock Exchange (OSE), and topix index futures, listed in Tokyo, fell sharply to 162.4 trillion yen ($1.45 trillion) and 33.0 trillion yen ($295 billion), respectively, in 1993, down about 70 percent from the peak in 1991. In July 1993, the U.S. Treasury and Japanese Ministry of Finance agreed on a framework for regulating stock-index derivatives trading on the Tokyo Stock Exchange.

The Tokyo, Osaka, and Nagoya exchanges also trade stock-index options, with the combined turnover amounting to 2.0 trillion yen ($18 billion) in 1993, virtually all in Nikkei 225 options. On February 14, 1994, new capitalization-weighted Nikkei 300 stock-index futures and options products were listed on the OSE, designed to eventually replace existing Nikkei 225 derivatives.

Investment Trusts and Pension Funds

Investment trusts are Japanese mutual funds aimed primarily at retail investors. This market also has been lackluster during the past four years. At year-end 1993, the total amount of investment trusts outstanding fell to 50.7 trillion yen ($454 billion), down more than 10 percent from the peak of 59 trillion yen at year-end 1989. Nevertheless, the number of individual investment trusts jumped nearly 50 percent over the period to 6,086 at year-end 1993.

The number of licensed investment trust management companies (ITMCS) increased from 15 in 1989, all affiliates of Japanese securities companies, to 28 as of end-September 1994, including five foreign firms (one U.S./European joint venture and four European). Foreign entry into the ITMC business was first allowed in 1990. In 1993, investment advisory

companies (which are licensed to do discretionary fund management) were allowed to enter the ITMC market via subsidiaries. Seven additional domestic ITMCs, all affiliates of leading Japanese commercial banks, have been licensed on this basis thus far.

The corporate pension fund market has grown steadily over the past five years and reached 51.5 trillion yen ($515 billion) at the end of March 1994. This represents a roughly 50 percent increase from 1989. As of March 1994, the public pension fund market totalled roughly 45.7 trillion yen ($462 billion). Investment advisors were first allowed to manage a limited portion of corporate pension fund monies in April 1990. Previously, this business had been reserved exclusively for trust banks and life insurance companies. To employ investment advisors, pension fund sponsors are required to obtain a license from the Ministry of Health and Welfare (MHW). Of a total of 1,804 fund sponsors, 681 were licensed, and of these, 263 had employed investment advisors as of March 1, 1994.

Securities Exchanges

Japan has eight licensed securities exchanges, the largest of which are in Japan's three leading cities: Tokyo, Osaka, and Nagoya. Regular membership is limited to licensed securities firms, although banks may become "special members" of the Tokyo Stock Exchange (TSE) to participate in government bond and government bond futures and options trading. In addition, securities firms are permitted to join as ordinary or clearing members of the bank-sponsored Tokyo International Financial Futures Exchange (TIFFE), which was established in 1989. (See banking chapter for more details on TIFFE.)

Securities Companies

As of March 1994, there were 220 Japanese securities companies, of which 129 were licensed to engage in the full range of securities business. There also were 48 foreign firms (18 American), of which 43 were fully licensed. The four leading Japanese securities firms are well capitalized, with combined capital of approximately 400 billion yen ($3.6 billion), and provide a wide range of securities services both in Japan and abroad, where they face fewer restrictions than in the domestic market.

Regulatory Framework

Under the Securities and Exchange Law (SEL), the securities business in Japan is reserved for licensed securities companies. The SEL enumerates the classes of instruments that qualify as "securities" and provides the framework for government regulation. Participation in each of the four major securities activities — dealing, brokering, underwriting, and distribution — requires explicit approval from MOF. Occasionally, regulators have allowed

securities firms to handle other products (e.g., yen-denominated bankers acceptances, certificates of deposit).

Activities involving foreign currency exchange and cross-border transactions are regulated by the International Finance Bureau of the Ministry of Finance under the Foreign Exchange and Trade Control Law. Many cross-border transactions require either prior notice to MOF or prior approval.

Supervision and regulation of the securities industry is carried out by the Finance Ministry, the Securities and Exchange Surveillance Commission (SESC), and MOF-designated self-regulatory organizations. MOF has exclusive authority for licensing and retains broad discretion over the regulation and supervision of both domestic and foreign securities houses, ITMCs, and investment advisors, as well as the nation's eight stock exchanges. Within MOF, the Securities Bureau is responsible for most licensing and regulation in this sector.

Self-regulatory functions are carried out under MOF oversight on the established securities exchanges and in the Japan Securities Dealers Association (JSDA), which administers the over-the-counter market.

A series of securities market scandals that came to light in the summer of 1991 raised concerns about MOF's dual roles as industry regulator and industry advocate and prompted the creation of the SESC in July 1992. The new watchdog body has limited powers compared with the U.S. Securities and Exchange Commission — for example, it has investigatory/prosecutory responsibilities, but it is unable to levy penalties. Most of the staff of the SESC are seconded from MOF.

Regulatory Changes Since 1990

A series of measures have been taken since 1990 to liberalize and deregulate the domestic securities market. Some of the more significant changes are described here.

In April 1990, MOF introduced new risk-weighted capital adequacy requirements for securities companies, and two years later, in July 1992, announced the long-awaited repeal of the 10:1 gearing ratio of liabilities to capital. The 1990 National Treatment Study argued that the gearing ratio affected foreign firms disproportionately.

The Financial System Reform Act implemented in April 1993 permits Japanese banks in principle to engage in the securities business through separate subsidiaries. In implementing the law, however, MOF has permitted new bank subsidiaries to engage in only a limited range of securities activities. Thus, securities firms continue to have exclusive rights to broker equities, convertible bonds, and equity-warrant bonds and to underwrite

equities. As of March 1994, one city bank, three trust banks, two long-term credit banks, and the Norin Chukin Bank had set up securities subsidiaries, and six city banks had plans to do so within 1994. Another bank, Daiwa, was permitted by regulators to absorb an ailing, medium-sized Japanese securities firm in 1993.

In July 1993, MOF eliminated the qualification criteria for Euro-yen bond issues by nonresidents, and by the end of 1993, the ministry had removed the 90-day seasoning period on Euro-yen bonds issued by foreign sovereign and supranational issuers.

In the domestic corporate bond market, recent changes include expansion of the list of eligible issuers, some diversification of maturity structures, permission for issuance of parent company-guaranteed bonds, elimination of quantitative ceilings on corporate bond issuance, some enhancement of the use of bond ratings, broadening of access to shelf registration for new issues, limitation of the power of commissioned banks, and enhancement of disclosure. Reflecting mounting pressure from issuers and concerns about possible hollowing-out of the domestic market, underwriting and commission fees have been lowered several times. Meanwhile, the Japan Fair Trade Commission (JFTC) has stepped up its monitoring of questionable cartel practices in the Japanese financial industry. Book-entry delivery for domestic share certificates was introduced in 1991.

As one element of the overall financial system reform effort, MOF attempted but eventually abandoned — after an inter-ministerial turf battle — a plan to introduce a more comprehensive definition of a "security" under Article 2 of the revised SEL. Instead, in April 1993, MOF slightly expanded the positive list of permissible securities to include domestic and foreign commercial paper, foreign certificates of deposits, and a few asset-backed products. However, MOF retains discretionary authority to restrict the introduction of new products.

Aside from these legal changes, a number of new financial instruments have been created, including limited forms of floating-rate notes, currency option products, certain asset-backed securities, zero-coupon convertible bonds (but not zero-coupon straight bonds), dual-currency bonds, step-up/step-down bonds, commodity funds, subordinated-term and perpetual bonds, and preferred stocks. However, as discussed below, various restrictions still remain on certain interest-rate structures.

On June 28, 1994, MOF announced 39 financial/securities deregulation measures as part of the government's overall 279-point deregulation package. The package fell far short of fundamental reform of the domestic regulatory system, but it did include a few actions that addressed long-standing requests from the U.S. Treasury Department and the foreign financial community. These measures included: (1) liberalization of domestic trading of two OTC financial derivatives — forward rates agreements (FRAs) and forward exchange agreements (FXAs) — effective October 1, 1994 (banks can do both, but securities firms can

do only FRAs); (2) relaxation by March 1995 of the regulation on issuing yen commercial paper; (3) permission for all Japanese designated financial institutions to trade offshore listed stock and stock-index cash options directly by March 1995; (4) further relaxation of the eligibility criteria for Japanese and foreign bond issuers at home and abroad; and (5) permission for securities firms to do a slightly broader range of currency swap business.

Although quasi-securitization of financial claims is possible in Japan, numerous legal and administrative restrictions have hampered the development of a true asset-backed securities market in Japan.

U.S. PRESENCE IN THE MARKET

The total number of foreign securities houses with branches in Japan has declined to 48, from a peak of 53 in 1990. Of the total, 18 are U.S. firms, down from 22 in 1990. In addition, 92 foreign securities firms (14 American) have established representative offices in Japan. No foreign firm has yet established a securities subsidiary in Japan, although MOF did announce in 1986 that it was prepared to consider subsidiary applications.

In the past, the primary focus of foreign securities firms' business was on the intermediation of international securities transactions, selling foreign securities to Japanese investors or selling Japanese securities to foreigners. Beginning in the late 1980s, foreign firms sought to compete in the Japanese domestic debt and equity markets. Foreign firms have become particularly active in the Japanese government securities market, expanding their clients to include domestic institutional investors. Foreign firms (predominantly American) were awarded roughly 12 percent of the total 10-year JGB auction amount in Japanese fiscal year 1993, compared with 6 percent in the preceding year. U.S. firms also have facilitated Japanese investors' access to the U.S. Treasury securities market.

Foreign firms also have become especially active in equities trading. U.S. firms have 10 of the 24 foreign-owned seats on the 124-seat Tokyo Stock Exchange. In 1993, the foreign share of secondary market turnover in equities approached 17.8 percent (see table below), contrasting sharply with the small shares that major foreign firms are allocated in domestic equity underwriting syndicates. U.S. firms also have been very active in derivative markets. Nine U.S. securities branches and one U.S. bank branch are TIFFE members.

Recent foreign securities houses' share of all turnover on Tokyo Stock Exchange (in percent)

1989	5.9
1990	8.8
1991	13.9
1992	19.9
1993	17.8

Despite this more active local presence, foreign securities firms' profitability has been eroded in recent years by the pressures of a sluggish Japanese economy, bearish financial markets, and rising costs of doing business in Japan. In fiscal year 1992 (latest available data), the combined operational and non-operational profits of the 49 foreign branches then in existence fell to 14 billion yen ($112 million) from 49 billion yen ($368 million) the previous year. (These results were still markedly better than those of Japan's 25 listed securities firms, which posted *losses* of nearly 352 billion yen ($2.8 billion) in FY 1992 due to sharp declines in brokerage commissions.)

In response to rising costs and diminishing returns, foreign firms have generally downsized their operations in Japan in recent years. As noted above, five foreign (including four U.S.) firms have withdrawn from the Japanese market since 1990.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In the 1970s, a highly restrictive regulatory system made U.S. and other foreign securities firms fringe players in the Japanese securities market. By 1980, only four foreign firms (all U.S.) had established Tokyo branches. In the 1980s, the U.S. presence increased substantially as Japanese financial markets were gradually opened and deregulated, partially as a result of the MOF-U.S. Treasury yen/dollar talks (see below). By the end of the decade, foreign securities firms were generally confident about the right to establish in Japan and, in principle, to enter most lines of business open to domestic counterparts.

Nevertheless, many entry barriers still remain in key areas of importance to U.S. securities firms, and more often than not, the barriers are in those key areas where U.S firms are most competitive and most likely a threat to the business of Japanese securities firms. Moreover, full access to the Japanese investor base and to the entire range of securities activities continues to be hindered by a number of regulatory and structural barriers. (It should be noted that these barriers also apply to Japanese securities firms.)

Entry and Establishment

The establishment of foreign securities companies in Japan is governed by two securities laws: the Foreign Securities Firms Law (FSFL) and the Securities Exchange Law (SEL). The FSFL primarily covers establishment of foreign branches, while firms wishing to establish as a subsidiary must apply under the provisions of the SEL. All foreign securities firms in Tokyo are currently established as branches, primarily as branches of offshore subsidiaries of the parent firm. The establishment of a representative office in Japan requires only prior notice to MOF. Although a reciprocity provision exists in Japanese banking law with respect to establishment, there is no legal reciprocity provision governing the establishment of foreign securities firms in Japan.

Application for establishment of an additional branch office of a foreign firm resident in Japan is treated as a de novo branch application. Each additional branch must be separately capitalized, in contrast to the treatment of a resident subsidiary's branches or those of a domestic securities firm. By year-end 1993, only 16 foreign firms had established more than one branch.

Prior to 1986, MOF's preference was for foreign firms to enter Japan as branches under the FSFL. In 1986, however, MOF announced that it would consider applications by foreign securities firms to establish subsidiaries under the SEL. Foreign firms nevertheless have continued to enter as or remain branches, possibly due to tax and operational considerations. Acquisitions, takeovers, mergers, or joint ventures involving a Japanese securities firm with either a domestic or foreign securities firm are regulated primarily by Japanese antimonopoly law. In general, a financial firm in Japan may not hold more than 5 percent of the equity, whether voting or nonvoting, of another firm, unless specifically approved by the Japan Fair Trade Commission. Although some foreign firms have reportedly considered entry into the Japanese market via this approach, there have been no mergers or acquisitions to date. MOF has affirmed in the past that an acquisition of a domestic bank by a foreign bank would be permitted.

As noted earlier, until the Financial System Reform Act was implemented in 1993, banks had generally been prohibited under the SEL (Article 65) from entering the securities business. However, in the late 1980s, MOF interpreted the FSFL to permit nearly 30 U.S. and European banks to open securities branches in Japan through overseas joint venture affiliates (in which the parent financial institution owned no more than 50 percent). MOF has not permitted overseas affiliates of Japanese banks to enter the domestic securities market under this interpretation.

Investment Trust Management

Entry costs into the investment trust management business are high and have the effect of deterring foreign entry. Companies wishing to manage mutual funds in Japan are required to maintain minimum capital of 300 million yen ($3 million) and a minimum net worth of 50 million yen ($0.5 million). In addition, integrated asset management firms wishing to engage in both the mutual fund and pension fund businesses must establish separate investment trust management and investment advisory companies, resulting in higher overhead costs.

These requirements make it too expensive for many foreign firms to enter the Japanese fund management business. Moreover, investment by ITMCs is limited in principle to defined securities under Article 2 of the Securities Exchange Law. Derivatives trading is generally discouraged. Investment in gold, land, and many other nonfinancial assets is prohibited.

These restrictions limit ITM product design and the competitive opportunities of foreign mutual fund managers.

In addition to high entry costs, restrictions on distribution limit opportunities for foreign ITMCs. Current law in Japan defines an investment trust as a security, and only securities firms may market securities products in Japan, although direct sales are permitted. Since foreign securities firms lack retail networks, foreign investment trust management companies must market their products through Japanese securities firms, which typically are the parent companies of their Japanese mutual fund competitors. Unlike the United States, banks are not allowed to act as sales agents of investment trusts.

ITMCs affiliated with the "Big 4" Japanese securities firms (Nomura, Daiwa, Nikko, and Yamaichi) had a dominant 70 percent market share in 1993; foreign firms' share was just 1.8 percent.

Underwriting Corporate Securities Issues

Despite persistent efforts and growing domestic client bases, foreign securities firms are rarely able to secure more than a minimal share in corporate underwriting syndicates. The yen-based corporate bond and equity new issue markets are essentially locked up by the Big Four Japanese underwriters. No foreign securities firm has ever lead-managed a nongovernment domestic corporate bond or equity issue in Japan, even though U.S. securities firms have excelled in underwriting yen issues in the Euro-yen and nondollar corporate securities markets in other major financial centers. Moreover, U.S. securities firms have participated in the lead management of only six issues in total, but in each case a Japanese partner acted as co-lead. All six issues were for NTT, a quasi-government telecommunications company. This situation is anomalous when viewed against foreign firms' share of secondary market trading in Japan and their leading positions in underwriting offshore bond and equity issues.

The minimal presence of foreign underwriters in lead-managing corporate bond and equity issues in Japan stems in large part from a number of regulations and industry practices endorsed by the Finance Ministry that govern who can issue corporate securities in Japan, the types and structures of products that may be issued, and the amounts and types of products that institutional investors may purchase. These regulations and practices include the following:

- Through the use of administrative guidelines, MOF sets minimum rating requirements and other financial criteria (such as minimum net worth) for corporate bond issuers. These restrictions narrow the pool of eligible issuers and limit business opportunities for U.S. securities companies. Minimum rating and net worth requirements have been relaxed in recent years, but restrictions remain. These regulations prevent smaller firms from

participating in the capital markets and have the effect of preserving their business for Japanese banks.

- A combination of regulations and informal guidance frustrates, and often prevents, securities firms in Japan from introducing new securities products and services, and in many cases from marketing securities products that are widely available in other major financial markets. The relatively narrow definition of a "security" under Article 2 of the Securities and Exchange Law is a principal obstacle in this regard. New securities instruments are prohibited "in principle" unless specifically approved by the Finance Ministry, on a case-by-case basis, and in some cases, on a transaction-by-transaction basis. The list of permissible securities under Article 2 has been expanded somewhat in recent years, but until any new product — except those explicitly excluded for prudential reasons — can be introduced in principle, this limitation will remain a significant barrier to foreign securities firms with a competitive advantage in offering innovative new products. For example, the SEL permits only those equity derivatives instruments that are traded on a regulated exchange, thus restricting the ability of U.S. firms (as well as Japanese securities firms) to meet their clients' needs by providing specifically structured, non-exchange traded derivative instruments to institutional investors. The prior reporting/prior approval framework of the Foreign Exchange and Trade Control Law is another barrier when the new product has a currency exchange component or involves a cross-border trade. Foreign firms have also questioned the need for multiple personal visits to various MOF bureaus to gain new product approval, as well as the general lack of transparency in the approval process. U.S. firms also have expressed concern that MOF consults with Japanese competitors, indirectly via the JSDA, in the course of reviewing new product applications by foreign firms. Many U.S. securities firms view these constraints as an explicit attempt by Finance Ministry officials to keep foreign securities firms at a competitive disadvantage by denying them the opportunity to market in Japan their most competitive skills.

- The above restrictions prohibit the development of an asset-backed securities market in Japan, a market that is of considerable importance to U.S. securities firms, which excel at underwriting these kinds of instruments.

- Despite gradual liberalization and commitments to further reform, MOF continues to limit the types of corporate bonds that may be issued in Japan and regulates their interest rate structures.

- MOF administrative guidelines set limits on the amounts and kinds of investments that life insurance companies and mutual funds may make in various financial instruments, albeit they are free to make investments pursuant to MOF's investment framework. These restrictions hamper distribution capacity for foreign securities firms by limiting the kinds of products they may market to Japan's leading institutional investors.

• A "10,000-share rule" limiting the number of shares that can be placed with a single investor, individual or institutional, was imposed by the Japan Securities Dealers Association (JSDA) in the wake of the securities scandals in the summer of 1991, in order to reinforce new legal prohibitions on loss compensation. (Preferential allocation of new public offerings had been one means by which Japanese securities companies compensated favored customers for poor performance of their existing securities portfolios.) A broad range of exceptions to the 10,000-share rule are granted, but foreign firms view the rule as impeding their ability to distribute shares to their (mainly institutional) clients. (Note: A separate "30 percent rule" imposed by the JSDA, which limited the distribution share of each securities house in the syndicate and was listed as a concern in the 1990 report, was eliminated in July 1992.)

Cross-Border Capital Transactions

Japan maintains extensive foreign exchange controls now rare in other industrialized countries. These restrictions reinforce restrictions on securities products and investment decisions by domestic investors.

In principle, cross-border transactions require prior notification of the Ministry of Finance, and in a number of important cases, prior approval from the ministry. These requirements also are often used to force firms to restructure products offshore to comform with domestic regulations. In this way, U.S. securities firms often face difficulties in underwriting securities products offshore for Japanese residents because of the prior notice/approval requirements.

Moreover, under the Foreign Exchange Law (FEL) and Foreign Securities Firms Law, only "designated financial institutions" (DFIs) enjoy direct access to certain overseas portfolio investments. Non-DFIs — including major Japanese corporations — are forced to channel the bulk of their overseas portfolio investments through a MOF-licensed resident securities firm or authorized foreign exchange bank in Japan, depending on the type of transaction involved. In this way, access to overseas markets by non-DFIs is restricted to the range of products permitted resident securities firms as governed by domestic regulation. Not only does this protect Japanese financial institutions from offshore competition, but it provides a regulatory means by which MOF can limit and/or direct Japanese investor activity. MOF has raised the ceilings on overseas accounts held by non-DFIs and permitted foreign securities firms not licensed in Japan to offer securities on a "non-solicitation" basis to individual and corporate investors resident in Japan. However, these changes leave intact the basic regulatory structure, and the overseas deposit ceiling of roughly $1 million is of little consequence for large Japanese investors.

U.S. securities firms also have been frustrated by Japanese laws (primarily the FEL) that prohibit them from offering a full range of foreign exchange services in Japan, even those directly related to their underlying securities business (securities firms have gotten around

this prohibition by establishing bank branches in Japan). In December 1993, MOF allowed securities firms to act as currency swap partners when their overseas subsidiaries underwrite Japanese bond issues. In addition, relaxation of barriers to cross-sectoral entry has enabled securities firms to engage in foreign exchange business indirectly through bank affiliates. Again, however, these changes leave the fundamentally restrictive regulatory structure intact and prevent U.S. securities firms from directly offering a full range of foreign exchange services.

Pension Fund Management

A variety of legal restrictions has limited the ability of investment advisory companies to manage Japanese pension assets — a roughly $1.0 trillion market. Specifically, investment advisors are barred from managing most public pension fund assets and granted access to only a limited portion of corporate pension funds. In addition, a number of operational constraints — including lack of standardized performance evaluation criteria, use of book-value rather than market-value accounting, and asset allocation guidelines imposed on fund sponsors and managers — impede competitive market access by fund managers based on performance. These operational constraints also represent a major impediment to U.S. trust banks, of which there are six, from gaining access to the market.

In recent years, MOF has taken steps to liberalize access by investment advisors to the private pension fund market. These include modifications to entry restrictions, asset allocation guidelines, and minimum contract size rules. In November 1994, MOF eliminated the artificial distinction between "old" and "new" monies in a certain class of pension funds. (Investment advisors had been barred from managing the former.) Nevertheless, the remaining restrictions keep competitive U.S. asset managers marginalized as players in the Japanese pension fund management business. Investment advisers previously had access to only 18 percent of the total market. The total market share of foreign asset managers in Japan (including foreign trust banks) is just 1.0 percent.

Transparency

Inadequate transparency of policies and regulations, and their formulation, has been one of the most frequently mentioned hurdles encountered by foreign securities firms in Japan. They cite the fact that many rules and procedures, let alone administrative guidance, are not written down, proposed changes in policy are not aired publicly or in a timely fashion, and foreign firms are frequently left out of informal consultations between market participants and MOF officials.

MOF has made some procedural improvements to enhance transparency over the past few years. Foreign firms have been invited more frequently to participate in, and testify as witnesses before, MOF advisory councils. MOF also has been increasingly willing to

confirm in writing the lack of administrative controls on certain types of transactions. For example, in announcing a series of new liberalization/simplification measures for the securities industry in the fall of 1993, MOF confirmed that individual investment trust management companies can freely determine their fees. In September 1994, MOF confirmed in writing that a certain class of asset- backed securities could be issued offshore and re-sold in Japan, subject to a number of restrictions, the most important of which was nonresident securities firms will not be able to market the instruments or provide liquidity through secondary market trading.

However, foreign firms believe that even where they have been invited to participate in MOF-sponsored advisory bodies, the real decisions often appear to be made elsewhere. Domestic institutions continue to enjoy better communication with regulators and privileged access to information, while foreign firms have had difficultly breaking into the dialogue. Moreover, given the Japanese regulatory approach that activities are restricted in principle unless explicitly permitted, even written confirmation of a lack of certain regulations does little to clarify the full range of permissible activities.

FINANCIAL MARKET DISCUSSIONS

The U.S. Treasury Department and Japanese Ministry of Finance have been engaged in financial market discussions for over a decade. In preparing the joint Report on Yen/Dollar Exchange Rate Issues, issued in May 1984, and in subsequent meetings over the next several years, the two sides focussed on measures to liberalize Japanese domestic financial markets, primarily by deregulating interest rates and creating an attractive money market, to internationalize the yen, primarily by removing restrictions to a freely functioning euroyen market, and to improve foreign firms' access to the Japanese financial market across a range of market sectors. In April 1988, the agenda of these discussions was broadened to include additional U.S. and international issues, and the group was renamed the U.S.-Japan Working Group on Financial Markets.

Although many of the specific commitments by the government of Japan in the 1984 yen/dollar report and in follow-up discussions have been met, a number of significant regulatory and structural barriers to full equality of competitive opportunity by foreign financial institutions in Japan remain. These issues are being taken up as one of the sectoral "baskets" of the U.S.-Japan Framework for a New Economic Partnership, launched in July 1993. The working group on financial services under the framework met eight times between July 1993 and October 1994. The goal of Treasury's negotiators is to obtain a comprehensive agreement that addresses all of the fund management, securities underwriting, and cross-border issues noted above.

CONCLUSION

Since the 1990 National Treatment Study, the government of Japan has undertaken a number of further measures to deregulate and develop the domestic securities market. These include easing of the eligibility criteria for domestic corporate bond issuance, limited expansion of the "positive list" of permissible securities, permission for foreign investment trust management companies to establish in Japan, opening of a somewhat larger share of the pension fund market to investment advisory companies, relaxation of certain controls on cross-border capital transactions, and enhancement of regulatory transparency.

These improvements, however, have generally been incremental and piecemeal. They have left in place a number of regulatory and structural obstacles that still prevent foreign securities firms from entering certain key lines of business, becoming more active participants in the domestic underwriting business, handling a range of cross-border capital transactions appropriate to Japan's state of development, and benefiting from their proven expertise in the area of asset management. As a result, foreign securities firms are prevented from achieving a degree of success comparable to what they have been able to achieve in other markets. In sum, the Japanese securities market remains characterized by a lack of full equality of competitive opportunity for foreign firms.

Notes:

(1) The following exchange rates between the U.S. dollar and Japanese yen were used throughout this chapter (annual average unless otherwise indicated):

CY 1989: $1 = ¥137.96; FY 1989: $1 = ¥142.83
CY 1990: $1 = ¥144.81; FY 1990: $1 = ¥141.30
CY 1991: $1 = ¥134.54; FY 1991: $1 = ¥133.18
CY 1992: $1 = ¥126.65; FY 1992: $1 = ¥124.80
CY 1993: $1 = ¥111.18: FY 1993: $1 = ¥107.84
March 31, 1994: $1 = ¥102.80

(2) The Japanese fiscal year begins on April 1 of the year indicated and ends the following March 31.

REPUBLIC OF KOREA

BANKING

SUMMARY

The Korean government has tightly controlled the country's financial sector for more than 30 years, using directed credit and preferential interest rates as an instrument of industrial policy. As a result, the emergence of a strong, competitive banking system has been retarded. In response, nonbank financial institutions have become increasingly important in the financial system and the role of banks has been significantly reduced. This development has been further amplified by the worldwide trend towards greater use of nonbank financial instruments. The government has begun to implement a five-year program of finance sector reforms announced in May 1993, termed the "Blueprint," which will reduce or remove some of the controls on the banking system.

The banking system in Korea comprises 14 nationwide commercial banks, 10 regional banks (one in each of Korea's 10 provinces), branches of 52 foreign banks, and six "specialized" banks. The latter institutions, which are directed and supervised by the Government, were originally created in the 1960s to provide funds to particular sectors where credit was insufficient, but recently they have expanded into commercial banking.

Foreign banks have experienced difficulties both in gaining market access to Korea and in terms of limitations on their operations once established. Although the government recently simplified the requirements for opening a foreign bank branch, evidence is insufficient to judge whether entry into the market has become easier. However, the controlled nature of the financial system and differential treatment in a number of areas makes it difficult for foreign banks to compete with domestic banks on an equal footing. For example: foreign banks, but not domestic banks, are required to capitalize each sub-branch. Foreign banks are disadvantaged with respect to access to local funding, and they find it difficult to exploit competitive advantages by introducing new financial products. In addition, the use of branch capital to define certain credit and funding limits also serves to place foreign banks at a competitive disadvantage.

There are 11 U.S. banks in Korea operating a total of 25 branches located in Seoul and Pusan. In addition, two U.S. banks have representative offices in Korea. One U.S. bank has a minority interest in a joint venture bank, and three have interests in nonbank financial institutions.

The most recent discussion with Korean officials was held in October 1994, in Madrid, continuing a regular bilateral formal and informal dialogue on financial policy issues. U.S. officials have consistently urged the Korean government to address the market access and national treatment issues on the bilateral agenda by improving local currency funding sources, enhancing regulatory transparency, and providing national treatment for U.S. banks. In earlier meetings beginning in 1991, U.S. officials had urged the Korean government to develop a

specific timetable for the implementation of a comprehensive blueprint for financial sector liberalization measures.

U.S. concerns about market access and national treatment also were the subject of numerous sets of negotiations in the context of the Uruguay Round.

In June 1993, the Ministry of Finance announced a Blueprint for Financial Sector Liberalization that provided a timetable for deregulating many aspects of the government's financial sector controls and allowing foreign banks greater freedom to compete. Principal elements of the Blueprint include interest rate deregulation, improvement of credit control management, development of the short-term money market, conversion to an indirect system of money supply management, and capital account and foreign exchange liberalization. However, the Blueprint does not address many of the complaints of U.S. banks, including the use of branch versus global capital for regulatory purposes and the lack of transparency and inconsistency in the application of government regulations.

DESCRIPTION OF THE MARKET

For more than 30 years, the Korean government has tightly controlled the country's financial sector, using directed credit and preferential interest rates as an instrument of industrial policy. In an effort to enhance competitiveness, however, the new Korean administration in May 1993 announced a multiyear program of financial sector reform aimed at decontrolling interest rates, deregulating financial institutions, and promoting greater private sector autonomy. Many of the reforms will benefit foreign as well as domestic banks and other financial institutions. However, some critical measures for foreign banks, such as full won convertibility and freedom of capital movements, are not scheduled to be achieved until 1996-97.

The banking system in Korea is comprised of 14 nationwide commercial banks, 10 regional banks (one in each of Korea's 10 provinces), branches of 52 foreign banks, and six "specialized" banks. Foreign banks also operate 23 representative offices.

The 14 nationwide commercial banks, three of which were established in 1989, have traditionally been subject to hands-on government involvement. The government retained majority ownership in five of the major institutions until 1983 and controlled the selection of all bank presidents until the current administration took office in 1993. Although the commercial banks continue to play a significant role in Korea's banking system, they have lost considerable market share over time to the specialized banks and the less restricted nonbank financial institutions. Total assets of the nationwide commercial banks amounted to about 232 trillion won ($316 billion) at the end of 1993. They hold approximately 44 percent of the banking system's deposits. Borrowings from the Bank of Korea (BOK) accounted for an additional 9.5 percent of their funding in 1993. They tend to focus on short-term lending.

The six specialized banks, directed and supervised by the government, were originally created in the 1960s to provide funds to particular sectors where credit was insufficient. They are subject to the same interest rate controls and reserve requirements as commercial banks, but have the advantage of being able to borrow directly from the government and issue debentures. They have recently expanded into commercial banking as well, and now deposits represent their main source of funds, providing 43 percent of funding in 1993. The specialized banks' assets amounted to 79 trillion won ($98.4 billion), and they held 34 percent of the total assets of deposit money banks in 1993.

The 10 smaller regional banks are oriented toward serving the small and medium-sized enterprises in their provinces. Each has three branches in Seoul and additional branches in their respective provinces. Total assets of the regional banks amounted to 25 trillion won ($31.1 billion) or 10.7 percent of the total assets of commercial banks in 1993.

The primary regulator of the banking system is the Bank of Korea (BOK), comprised of the Monetary Board, charged with overall responsibility for formulating and administering monetary and credit policies, and the Office of Bank Supervision (OBS), which supervises banking operations. The Ministry of Finance also plays an important regulatory role through its policy-making function and its chairmanship of the Monetary Board.

Nonbank financial institutions (NBFIs), introduced in the 1970s to attract so-called "curb market" funds into the organized financial sector, are also growing in importance as competitors for the commercial banks. NBFIs may apply higher interest rates on their loans and deposits and enjoy greater freedom in the management of assets and liabilities than banks. As a result, NBFIs have significantly increased their market share through the 1980s. NBFI's share of total financial sector assets rose from 30 percent in 1980 to 63 percent in 1992, and of total loans from 35 percent to 56 percent. According to the BOK, NBFIs in Korea include three development banks (the Korea Development Bank, the Export-Import Bank of Korea, and the Korea Long Term Credit Bank), 24 investment and finance companies, 8 investment trust companies, 6 merchant banks, 31 life insurance companies, and more than 4,000 savings institutions.

U.S. PRESENCE IN THE MARKET

52 foreign banks from 14 different countries have branches in Korea, with a total of 72 branches in Seoul, Pusan, Inchon, and Taego. Virtually all have tended to specialize in wholesale banking. Total assets of foreign banks amounted to 17 trillion won ($25.5 billion) in 1992, or 6.8 percent of total assets held by deposit money banks. There also are 23 representative offices of foreign banks in Korea.

The 11 U.S. banks in Korea have a total of 25 branches located in Seoul and Pusan. As of mid-year 1992, U.S. bank branches operating in Korea held a total of 6 trillion won ($7.7 billion) in assets, or 2.4 percent of total assets of deposit money banks.

Two U.S. banks have representative offices in Korea. One U.S. bank also has a noncontrolling interest in Koram Bank, a joint venture with Korean investors, with assets of 4.7 trillion won ($6.0 billion) in 1992. Three U.S. banks each have a noncontrolling interest in a nonbank subsidiary or affiliate, which include a leasing company, two merchant banks, and a credit card company.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In its early years of economic development, Korea needed foreign exchange to build its export-led economy and support its companies in their overseas activities. Until Korea began to register current account surpluses in 1986, foreign banks were a key source of foreign exchange for the Korean economy. To encourage foreign banks to enter the Korean market, the government provided them relatively favorable treatment vis-a-vis the domestic banks in some respects.

With Korea's shift into current account surplus in 1986, its need to swap local currency with foreign banks to obtain foreign exchange has diminished and its policy has shifted to one of eliminating aspects of regulations that are preferential for foreign banks. In one important example, the Korean government began to reduce foreign bank swap limits in 1987, cutting them by 10 percent in 1987 and 1989. With the reduction in their local currency lending capabilities, foreign banks' ability to develop and serve their customer base has eroded. Among all deposit money banks, the foreign banks' share of won currency loans and discounts dropped from 5.8 percent in 1987 to 2.5 percent in 1993; their share of demand and time deposits fell from 1.3 percent to 0.42 percent in the same period. Foreign banks share of total assets dropped from 7.7 percent in 1987 to 4.9 percent in 1993.

In Financial Policy Talks held in May 1991, the MOF agreed to suspend further reductions in the swap lines, at least temporarily. The MOF also promised to discontinue the practice of reducing swap facilities on a one-for-one basis when foreign banks increase their capital in Korea. The MOF also agreed to consult with the U.S. banking community and other interested parties before further reductions are implemented. Although no further cuts in the swap lines have been made, in late 1992 the authorities modified the pricing mechanism associated with such funds' sourcing, without any prior discussion with affected banks. The net affect of the change was an increase in the cost of such funding for several U.S. banks and an increase in the lending rates of many foreign banks.

In response to protests from the banks, MOF revised the swap facility rules effective June I, 1993, to calculate the rate based on each bank's cost of lending rather than an average of all

foreign banks. Although this change was welcomed by the banks, it fell short of their preference for being allowed to obtain funds locally at market rates.

Under Article 27 of the Banking Act, all banking institutions are prohibited from purchasing or retaining ownership of shares in any other banking institution, or shares in excess of 10 percent of the shares issued by any other business firm, except when given approval to do so by the banking regulators. Although the Banking Act in principle permits foreign banks to establish banking subsidiaries with the approval of the Monetary Board, MOF has not allowed foreign banks to do so. Foreign banks have been permitted to establish operations in Korea by opening a branch of the parent bank, with the approval of the Ministry of Finance and the Bank of Korea, or by opening a representative office, with the approval of the Bank of Korea.

According to criteria announced by the Ministry of Finance in 1989, to be eligible to open an initial branch in Korea, a foreign bank must be in the ranks of the top 500 banks in the world on an asset basis and meet other criteria including minimum asset levels. The Ministry of Finance has since simplified the requirements for branch opening, although the requirement that the foreign bank rank among the world's top 500 remains. The ministry also transferred responsibility for accepting applications to the Office of Bank Supervision, at the Bank of Korea. Under current requirements, before a foreign bank can establish a branch it must maintain a representative office for at least one year, although the government has shown some flexibility in implementing this requirement.

Foreign banks are disadvantaged with respect to adding sub-branches. Each foreign bank must individually capitalize each branch with three billion won as if it were a separate bank. There is no individual branch capital requirement for domestic banks. U.S. banks argue that this discriminatory requirement makes foreign bank branching prohibitively expensive.

The ability to acquire local currency funding at reasonable prices is a critical question for foreign banks. One important source of funds is certificates of deposit (CD). Foreign banks were authorized to issue negotiable certificates of deposit in September 1986. However, since CDs are one of the few short-term instruments for which deposit rates have been decontrolled, the Korean government has established ceilings on CD issuance by banks to prevent a shift of funds out of other instruments with interest rates that remain controlled. The government has periodically raised the limits as issuance of CDs by domestic banks approached the ceiling. As a result of the most recent increase announced in February 1994, foreign banks are permitted to issue CDs up to 300 percent of paid-in capital plus legal reserves or 25 billion won, whichever is larger. No foreign bank is currently near its limit on CD issuances. In July 1994, the permissible CD maturity structure was expanded to 60-270 days, compared to the previous 90-180 days. Despite these improvements, banks would like to see removal of the maturity limits and issuance ceilings that would allow CDs to function as more flexible and liquid funding instruments.

In October 1989, the Korean government integrated the local currency call market to increase its efficiency. The market had previously been segregated into two separate trading sessions, one for domestic banks and one for foreign banks and nonbank financial institutions. Although the integrated market initially appeared to be developing effectively as an alternative source of won funding, U.S. and other foreign banks have in 1994 encountered difficulty in obtaining funds from domestic banks, and obtaining them at competitive rates of interest when they are made available. Foreign banks were often quoted rates two to five percentage points higher than rates quoted for domestic banks.

Acknowledging that discrimination existed, the MOF in May 1991 revoked the license of the Korea Financial Telecommunications and Clearing Institute (KFTCI), which is owned by the domestic banks, to act as a broker in the call market. Six short-term finance companies were designated to become new call market brokers, through which all participants were to deal. The Finance Minister later met with the heads of Korean banks to deliver a strong message that collusive behavior would not be tolerated.

In 1992 the MOF announced new measures to enhance the efficiency of the call market. The main element of the reform was the introduction of a "blind brokerage system" in which banks would conduct their call market transactions through an intermediary institution.

Recently, the financial markets have been somewhat more liquid, which has provided foreign banks with a measure of temporary relief for the problem of local currency funding, particularly by making it easier for them to engage in interbank borrowing. Previously, inadequate access to reliable sources of local currency funding was a major chief impediment to U.S. banks' ability to compete effectively in Korea. However, the improvement will likely not be sustained and the interbank call market loans typically carry high interest rates. As noted earlier, foreign banks do have access to BOK foreign currency swap lines, but the lines are limited and consequently do not offset other disadvantages foreign banks face in assuring local currency funding.

Another important issue that hampers the ability of foreign banks to compete in Korea is the Korean government's use of local branch capital as the benchmark for determining a variety of funding and lending limits. As of January 1992, the total local capital of a foreign bank (inclusive of all branches) is viewed collectively for purposes of establishing lending limits. This step was an improvement over the previous stringent rule, which required each sub-branch to maintain its own separate capital to support its operations. However, the current treatment differs from that followed by the U.S. and most other industrialized countries, which bases prudential lending limits on the worldwide capital of a foreign branch's parent bank. Although domestic banks are also subject to limits based on size of capital, the "capital" employed in their case is the entire bank's capital.

In addition, the treatment of retained earnings in the definition of capital further hamper foreign banks. For example, although retained earnings are currently included in the formula to

determine lending, they do not count when calculating CD limits. As pointed out above, CDs are an important source of funding for foreign banks, which do not have as large a retail deposit base as their domestic competitors.

The "trust" business in Korea (which differs from funds management as practiced in the U.S.) is another potentially promising source of won funding. Trust funds are not subject to Bank of Korea reserve requirements. Regulations governing management of trust accounts are less restrictive than in the more controlled loan and deposit sector, and yields on trust accounts with maturities of more than two years have been deregulated since December 1988. Foreign banks were given approval to compete in portions of the trust business in 1985.

The Korean government has eliminated the three-year delay new foreign banks previously faced in receiving trust licenses. It now provides each new foreign bank branch with a trust license when it opens. Since early 1990, both foreign and domestic banks have been required by the written guidelines for the management of the trust business to use a certain portion of deposits taken in trust to underwrite Monetary Stabilization Bonds (MSBs), the government's primary tool of liquidity control, at primary issue. This further limits the effectiveness of trusts in compensating for shortfalls in local currency funding available through swaps. Although interest rates on MSBs were decontrolled in the fall of 1993, the MSB underwriting requirement is not due to be abolished until 1996-97, when the government plans to switch to a monetary policy system based on open market operations. As a first step to abolishing the MSB purchasing requirement, ROKG eliminated this requirement for the specific money trust accounts as of January 1994.

There are some areas where foreign banks receive advantageous treatment, compared to their domestic competitors. As a rule, foreign banks have been fully or partially exempted from informal requirements levied on domestic banks for purposes of credit allocation, liquidity control and to support other economic and social policy objectives. Foreign banks are not required to purchase monetary stabilization bonds in the primary market (except for trust accounts as discussed above) and are required to lend only 25 percent of their total loan portfolio to small and medium-sized industry (domestic banks are required to lend 45 percent). Most importantly, the government has provided foreign banks exchange risk-free dollar-won swaps from the BOK to finance local currency funding. In addition, although interest rates on trust accounts with maturities of more than two years and on CDs have technically been liberalized, domestic banks continue to be subject to MOF "guidance" when setting rates. MOF maintains that foreign banks are immune from such guidance.

Following are some other issues affecting foreign banks' ability to compete effectively in Korea.

- Local banks have access to government funds, including those available through the policy loan program, while foreign banks do not.

• Under the Alien Land Acquisition Act, foreign banks' ownership of commercial and residential premises is extremely restricted, affecting their ability to control costs. Although foreign banks may acquire land for commercial or residential purposes with Korean government approval, such approval is granted on the basis of nontransparent criteria and in practice is extremely restricted. Only two of the 14 U.S. banks own commercial premises and three own residential real estate. No foreign bank has been given approval to obtain property for about 10 years.

• Korean government regulations haved inhibited foreign banks from taking or enforcing certain types of mortgages, particularly impacting foreign banks that wish to have collateral positions on an equal basis with domestic banks. Recent changes to the Alien Land Acquisition Act and implementing regulations have eliminated some of the problems faced by foreign banks in these areas, but difficulties remain. Because titles to land and improvements are distinct, government regulations can result in a diminished value for land owned by a bank when acquired through foreclosure.

• When foreign banks access the rediscount window of the BOK, they must meet a requirement to make 35 percent (as opposed to the usual 25 percent) of their loans to small and medium-sized industries. This is an apparent advantage when compared to the 45 percent requirement for domestic banks. However, foreign banks tend to specialize in wholesale banking and do not have a large client base of small and medium-sized firms. As a result, the 35 percent requirement is so significant a disincentive that foreign banks do not access the rediscount window. An August 1, 1994 amendment to MOF rules may mitigate this disadvantage to some extent by counting purchases of convertible bonds issued by small and medium-sized companies and bonds issued by the Industrial Bank of Korea towards the 35 percent requirement.

• Because U.S. banks have a comparative advantage in foreign exchange products, government rules regulating foreign exchange transactions impose a particularly heavy burden on them. OBS regulations until recently required that documentation accompany most forward exchange transactions to prove the funds were to be used for legitimate business purposes and not speculation. Revisions made to the regulations in late 1993 eliminated the requirement for most, but not all transactions. In addition, foreign banks' ability to introduce new foreign exchange products is extremely limited.

• The MOF places limits on foreign and domestic banks' overbought and oversold foreign exchange positions. In changes adopted in October 1993, the MOF raised the limits to the larger of: (1) a specified percentage of the previous month's purchases of export bills, (2) $20 million, or (3) 10 percent of bank capital. As of November 1, 1994, the limit on the overbought position was raised to the larger of (1) a specified percentage of the previous month's purchases of export bills, (2) 15 percent of capital, or (3) $30 million. Limits on the oversold position were not changed. Since the definition of capital applies only to foreign banks' branch capital, for most U.S. banks this amount will be less than the absolute limit of $20 million for oversold and $30

million for overbought. While welcoming the enlarged limits, U.S. banks favor the elimination of ceilings on overbought and oversold positions.

- Introduction of new products and services continues to be of concern for the foreign banking community in Korea, particularly as this is an area in which they have a competitive advantage. Banks are currently required to seek official permission before introducing new products and services. Korea has committed in the course of Uruguay Round financial services negotiations that "such products will be more widely allowed," but has offered no timetable or specific list of products.

- Foreign banks have been excluded from the process of registering foreign direct investment in favor of 29 domestic banks. In June 1994, the MOF published new guidelines regarding the registration of new foreign investment. The guidelines specified that the processing of applications and subsequent monitoring of FDI are the responsibility of local banks (MOF previously had this role). Foreign banks were specifically excluded from handling this business. MOF justified this decision on the basis that most foreign banks only have one branch, which is located in Seoul, and therefore cannot monitor foreign investment outside the capital. The decision limited foreign investor's choice of banks and is clearly discriminatory against all foreign banks. The Korean government may move on this issue in the near future. The MOF has indicated that foreign banks will be permitted to accept foreign direct investment applications beginning January 1, 1995.

- Bank are currently limited in their ability to engage in trade finance by onerous regulations maintained by the Korean government on deferred credit operations. Although some progress in this area has recently been made by expanding the repayment period to 150 days, Korea still lags far behind international norms in this regard. Although the Korean government has indicated that the deferred payment period will be incrementally raised to match international standards, no solid commitment or timetable for implementation has yet emerged.

FINANCIAL MARKET DISCUSSIONS

The Treasury Department has been working closely with the Korean Ministry of Finance (MOF) since 1986 to resolve problems faced by U.S. banks and other financial institutions in Korea. The Financial Policy Talks, as these discussions have come to be called, have focused in recent years on securing national treatment and market access for U.S. banks and securities firms operating in Korea, and on encouraging broader liberalization of Korea's financial sector. Over the last three years, Treasury has maintained the dialogue on financial policy issues with Korea through formal and informal rounds of the talks, and negotiations within the framework of the Uruguay Round.

In the early years of the financial policy talks, discussions between Treasury and MOF officials focused on various issues on a case-by-case basis. For example, during talks held in May 1991, the Ministry of Finance agreed to suspend further reductions in currency swap lines, and promised to discontinue the practice of reducing swap facilities on a one-for-one basis when foreign banks increase their capital in Korea. The Finance Ministry also agreed to consult with the U.S. banking community and other interested parties before further reductions are implemented.

As the dialogue progressed, it became apparent that many of the difficulties faced by foreign financial institutions in Korea were connected to structural distortions in the financial sector resulting from the highly regulated nature of the system and government's heavy-handed intervention. Treasury therefore shifted its focus in the talks from individual issues to the need for basic structural reform of Korea's financial sector. We continued, however, to negotiate regarding specific barriers, especially in the Uruguay Round context.

In March 1992, the Ministry of Finance took a significant step forward in the financial policy talks with the announcement that Korea would formulate a three-stage "Blueprint" for comprehensive financial sector liberalization. Treasury welcomed the move as an important shift away from the piecemeal approach to these issues taken in the past, and as a turning point in the dialogue. The Korean government also agreed to consult with the International Monetary Fund and World Bank during the Blueprint formulation process. The formulation of the short- and medium-term measures contained in Stages I and II of the Blueprint was completed in April and June 1992, and implementation of those measures is well underway. Although Stages I and II address a few of the individual issues faced by our financial institutions operating in Korea, the key areas needing attention are covered in the recently announced third and final stage of the Blueprint. The government of Korea has recently accelerated the implementation of Stage III, and some important measures have already been undertaken.

After the Kim administration took office in February 1993, the scope of the financial sector reform plan was expanded. A parallel package of reform measures to deregulate and enhance the competitiveness of the domestic financial industry was subsequently developed and incorporated into the new five-year plan.

Korea's most recent contribution to the bilateral dialogue was the establishment in early 1994 of an unofficial subcommittee to study and make recommendations on reform of the foreign exchange system. The subcommittee recently concluded the initial phases of its work, and has produced a draft Foreign Exchange System Reform Plan. The draft plan was used in a public hearing on foreign exchange system reform on September 8, 1994, in Seoul. The plan is designed to replace the existing Foreign Exchange Management Act (FEMA), and operates on the basis of three stages corresponding to 1995, 1996-97, and 1998-99, respectively. The plan is expected to be finalized by year-end 1994.

The most recent discussions with Korean finance ministry officials were held in April and October 1994. During these talks, Treasury officials urged their counterparts in the Korean Ministry of Finance to continue the process of financial sector liberalization and speed the implementation of the Blueprint, and address specific barriers affecting foreign financial firms. In the months ahead, Treasury anticipates additional negotiations focussed on securing a satisfactory Uruguay Round offer from Korea that commits to substantially full market access and national treatment for foreign financial institutions operating in Korea.

REPUBLIC OF KOREA

SECURITIES

SUMMARY

Over the last several years, Korea's securities markets have expanded substantially and recovered from the steep slide in share prices of 1989-90. Korea's stock market is now Asia's third largest. Rapid economic growth is one reason for the increase in securities activity. Another reason is the government's use of the stock market as a tool for attaining broader monetary and macroeconomic policy objectives.

The limited opening of the Korean Stock Market (KSE) to foreign investment in January 1992 was a significant first step. Foreign investors have responded enthusiastically to this opening and, as of September 1994, owned 8.6 percent of the market's total capitalization. However, the 10 percent foreign ownership limit has been met for at least 45 percent of the listed stocks already, and further growth in foreign ownership of Korean equities will be severely constrained unless the limit is raised substantially. Since most of the business of foreign securities firms is with foreign investors, the 10 percent purchase limit on shares imposes a severe limit on the potential growth in the operations of foreign securities firms in Korea. On October 5, 1994, the Finance Ministry announced that effective December 1, 1994, the ceiling on aggregate foreign purchases of listed stocks will be lifted to 12 percent, with a further lifting of the ceiling to 15 percent expected sometime in 1995.

In February 1994, the government announced somewhat more liberal rules for resident purchases by Korean investors of foreign securities. Under the new rules that took effect in July 1994, limits were raised on the maximum value of foreign securities that Korean companies may purchase, the limits were removed on purchases by institutional investors, and, for the first time, individuals were permitted to purchase foreign securities directly. Previously, individuals could make overseas portfolio investments only by buying shares in an investment trust. Nevertheless, the Finance Ministry tightly limited the scope for such purchases by restricting them to certain markets and certain types of securities. In addition, the Finance Ministry licensed only 24 Korean securities firms to execute orders from Korean clients under the new rules. No foreign firms were licensed because under the Securities and Exchange Act foreign firms may not engage in this kind of securities business.

Korean government rules impose significant restrictions on the ability of foreign firms to engage in the investment trust and investment consulting businesses. Beginning in January 1993, the government permitted foreign investment trust companies and investment consultants to set up representative offices and to participate in Korean firms through equity ownership. However, foreign firms are not permitted to own more than a 5 percent share in a Korean company, and total foreign ownership is limited to 10 percent. The government's blueprint for financial sector liberalization, announced in June 1993, calls for raising the limit on foreign equity participation

in the investment consulting and investment trust businesses. This limited change is planned for 1995; however, the Finance Ministry has yet to specify the amount of the prospective increase.

Although the Korean government has liberalized its rules for foreign investment, its policies in the securities sector have yet to address many of the more significant impediments to the operations of foreign securities firms.

The U.S. presence in Korea includes only three securities branches and eight representative offices.

DESCRIPTION OF THE MARKET

The Korean securities market has undergone a rapid expansion since the mid-1980s, and an especially rapid expansion in the last three years. In early 1992, strong foreign investment in the stock market following the government's partial liberalization of foreign ownership restrictions added to trading volume and boosted equity prices. In the second half of 1992, the government sought to reinvigorate the market by expanding the Stock Market Stabilization Fund and by requiring purchases of stocks by banks and insurance companies. And finally, in late 1993, the stock market received a further boost when the government encouraged the use of equities as a funding instrument for Korean companies.

The Stock Market Stabilization Fund

The Stock Market Stabilization Fund was created in 1990. The Ministry of Finance supported the creation of the fund to invigorate the sluggish Korean stock market. Korean securities firms contributed the initial capitalization of two trillion won, which was increased to four trillion won by the end of the year after the Finance Ministry urged banks and insurance companies, as well as listed firms, to contribute to the fund. Of total capital, slightly more than three trillion won was invested in listed stocks.

In August 1992, as part of a number of additional measures designed to energize the stock market, the Finance Ministry took steps to increase the fund's capital through contributions from newly established securities firms, institutional investors, and listed companies. Banks were required to contribute 25 percent of their incremental trust deposits, insurance companies were to contribute 20 percent of their revenue balances, and a number of funds, including government-owned pension funds, were required to provide at least 10 percent of their surplus funds. After those increases, the fund's total capitalization stood at 4.4 trillion won, of which 3.9 trillion won was invested in stocks.

In addition to energizing the stock market, the fund also has been used to dampen buying activity. When news recently broke that the ceiling on foreign stock ownership would be lifted,

early buying that would have pushed the market higher was offset and dampened when the fund stepped in and sold equities.

The Stock Market Stabilization Fund is directed by a 26-member board of directors comprised principally of representatives of Korean securities firms. A 12-member fund management committee manages the fund. Although the Ministry of Finance argues that the perception of its role in managing the market is exaggerated, foreign securities firms continue to believe the ministry plays an indirect role in the fund through its influence with the Korea Securities Dealers Association.

Market Indicators

The capitalization of the Korea Stock Exchange (KSE) has increased from 6.5 trillion won ($7.3 billion) at the end of 1985 to 112.7 trillion won ($139.5 billion) at the end of 1993. The value of bonds outstanding grew from 12 trillion won ($13.5 billion) to 78.9 trillion won ($97.6 billion) during the same period. At the end of 1993, the KSE listed 693 companies, only a slight increase over the number listed in 1989, but double the number listed in 1985.
For the 1994-1995 period, the number of listed companies is expected to rise as a result of another government measure: the Ministry of Finance's recent policy of allowing unlisted companies to go public through rights issues. In early 1994, several large Korean banks, previously confined to the over-the-counter (OTC) market, were permitted to list their stocks on the KSE. This rule change was part of the Finance Ministry's efforts to keep the market from overheating by increasing the supply of stocks.

Trading averaged 574 billion won ($715 million) and 35 million shares a day in 1993. According to Ministry of Finance, the turnover ratio of the KSE has been at least double that of the major U.S. and Japanese exchanges. The Korea Composite Stock Price Index, that measures aggregate price performance, closed 1993 at 866.2 points, a sharp rise from its 1985 closing level of 163 points.

The Ministry of Finance's Role in the Stock Market

The Ministry of Finance has had a significant impact on the KSE's dramatic expansion. The Finance Ministry affects the market by managing the market supply of issues. This is done through curbing or expanding rights issues by listed companies, controlling new listings on the exchange, managing the purchase and sale of monetary stabilization bonds (MSBs), and making credit available to institutional investors during market slumps. A provision in the KSE's rules limits a stock's daily price movement (2 to 6.7 percent, depending on the price of the stock). In the past, particularly during the market's slide in late 1989 and early 1990, demonstrators demanded government action to halt the decline. Again in December 1992, foreign capital inflows into the stock market, a product of the January 1, 1992, market liberalization, raised public concern about potential inflationary pressure. The Finance Ministry formally investigated

and issued a public report. More recently, in reaction to the conclusion of the Uruguay Round multilateral negotiations, Korean farmers protested against excessive profits being generated in the stock market and demanded that the government take appropriate measures to cool it off. And, as noted previously, the Stock Market Stabilization Fund has been used to cool down the market when buying is "too brisk" in the ministry's view.

Government attempts to closely manage stock market behavior have had the effect of partially insulating stock prices from market forces. The government uses various tools to manage the market, including regulation of stock issues, including issues from the Stock Market Stabilization Fund, and, most recently, reintroduction of a deposit requirement ratio for all stock purchases by institutional investors. The government has also required banks, securities companies, short-term financing companies, and merchant banks to purchase monetary stabilization bonds (MSBs) — a measure that can affect stock market activity. During the first quarter of 1994, when the market was experiencing fast-paced growth fueled by a recovering economy and signs of decreased government intervention, the Finance Ministry introduced a series of market-cooling measures to ward off possible adverse inflationary effects.

For foreign and domestic investors alike, the most interventionist measure was the introduction in January 1994 of the deposit requirement ratio (DRR). The DRR mandates that stock purchase orders for institutional and individual investors be backed up by a cash deposit equal to 40 percent and 80 percent of the stock value, respectively. The new regulation was particularly burdensome for foreign institutional investors, many of whom are constrained by home country law or internal guidelines from paying cash up-front for stock purchases. By March 1994, the Finance Ministry reduced the DRR to 20 percent for institutional investors and to 40 percent for individual investors in response to an unanticipated decline in the market. Foreign securities firms view the DRR negatively, contending that the Finance Ministry's efforts to manage the market are inconsistent with a free market and that it will ultimately deter prospective foreign investors. Despite these latest measures, the Finance Ministry maintains that it plans to decrease its involvement in managing the market.

Access by Foreign Investors

Under the Ministry of Finance's 1991 guidelines for opening the Korean Stock Market, foreign investors, in aggregate, were allowed to purchase up to 10 percent of the shares in a listed company. There is a 3 percent limit for individual investors, and foreigners may purchase in aggregate no more than 8 percent in two companies designated as "strategic" industries. Foreign investment must take place through a registered securities dealer. Since most of the business of foreign securities firms is with foreign investors, the 10 percent purchase limit on shares imposes a severe limit on their potential business growth.

On October 5, 1994, the Finance Ministry informed the press that the ceiling on foreign investment in listed stocks would be raised to 12 percent, beginning December 1, 1994, and that

it would be raised to 15 percent sometime in 1995. As part of the changes announced, the 8 percent limit on foreigners' purchases of stocks in Pohang Iron and Steel and the Korean Electric Power Corporation (deemed "strategic industries") will be raised to 10 percent. Because of the Finance Ministry's continuing concern over the impact of inflows of foreign investment on the domestic money supply, the timing of the hike in the ceiling to 15 percent will be timed in light of monetary, stock market, and exchange rate conditions.

The increase in the ceiling will help foreign investors. However, foreign investors are likely to continue to have to pay a premium for shares because their demand will be concentrated in just 12 percent of the shares of any one company.

Securities and Exchange Act

The major law governing the securities markets is the Securities and Exchange Act (SEA). It was enacted in 1962, but has been revised several times since then, most significantly in 1976. The SEA separates the banking and securities industries. Article 29 of the SEA requires banks and other financial institutions to obtain the Finance Ministry's approval to engage in securities business. Article 51 prohibits securities companies from engaging in a business other than securities business unless approved by the Finance Ministry.

The SEA established the Securities and Exchange Commission (SEC), which is subject to the supervisory authority of the Finance Ministry and supervises the securities industry through its executive arm, the Securities Supervisory Board (SSB). Other important institutions in the securities markets are the Korea Securities Dealers Association, the Korea Securities Finance Corporation, and the Korea Securities Depository Corporation.

Thirty-two domestic Korean securities firms are currently licensed by the Finance Ministry and operate under the Securities and Exchange Law. Six Korean securities firms have been licensed since 1977. Two foreign securities branches were authorized in 1991, five were authorized in 1992, two in 1993, and two in 1994 (as of June 30). In addition to these 11 branches, 26 foreign representative offices have been established in Korea. Since 1992, securities licenses have been issued to five domestic firms and to one joint venture firm. The firms' main activities are brokerage, dealing (trading for the broker's own account) and underwriting. In addition to the securities companies, merchant banks and short-term finance companies have been permitted to engage in certain restricted underwriting opportunities, mainly government and other public sector bonds.

Korean Stock Exchange

Although membership in the KSE is not limited to domestic companies, none of the foreign firms has opted for membership because of the prohibitively high cost. (However, the sole joint venture with foreign participation has a seat on the KSE.) The two types of KSE membership

are regular and annual. In 1993, the fees for a regular membership totalled about $15 million. The fees for an annual membership were lower — about $4.4 million — but annual memberships do not carry voting rights. Membership carries an advantage, i.e., reducing commission payments to other member brokers by about 30 percent. While these costs and benefits are the same for foreign and domestic firms, the Korean stock ownership ceiling imposed on foreign investors limits the size of the potential market for foreign firms and their ability to recover the high fixed cost of membership. Local representatives of foreign securities firms find the membership fees excessive, and U.S. securities firms have urged that the KSE lower them.

On the main exchange of the KSE, stocks are traded in two sections. The major difference between the two is that margin transactions are not permitted in the second section. A new listing is initially assigned to the second section for at least six months. After meeting criteria regarding the number of shareholders, trading volumes, after-tax profits, and the payment of dividends, the stock can move to the first section where margin transactions are allowed.

Individuals continue to dominate daily trading, accounting for 70 percent of shares traded; institutional investors trade 30 percent. Concerned about the relative weakness of institutional investors, the government is now increasing the number of institutions authorized as investors. Although foreign securities firms are not excluded from the KSE, they have been more active in the OTC markets, where shares trade at sharply higher premium but ownership limits do not apply.

There are two over-the-counter markets. One is the domestic market operated by the Korea Securities Dealers Association (KSDA), which is closed to foreigners; another is comprised of OTC trades among foreign investors. Since many of the most heavily traded stocks on the main exchange have reached the top of the 10-percent ownership limit, OTC trading has increased sharply. The value of these trades rose from 113 billion won in 1992 to 571 billion in 1993, and 765 billion won in just the first quarter of 1994. The government does not permit prices of these stocks to be publicized, reportedly because of the heavy premiums foreign investors are willing to pay for them.

Currently, Korea has no financial futures or options markets; however, a stock futures index is slated to be opened in 1996.

Bond Market

Korea's bond market is divided between government/public and corporate bonds. Bonds trade on both the main exchange and the over-the-counter markets. In 1993, the Korean debt securities market showed a substantial decline in market yields due to the government's flexible monetary policy. Yields on corporate bonds fell 3.06 percentage points to 14.07 percent for corporate bonds traded on the KSE, and 1.71 percentage points to 12.29 percent for bonds traded on the OTC market. Total trading volume during 1993 decreased sharply by 6 billion won, about 1 percent of the previous year's 634 billion won. Despite this decrease, volume in the OTC market recorded an increase of 76 percent in its annual growth. About two-thirds of Korea's outstanding bonds are government/public, mainly Monetary Stabilization Bonds (MSB) used to control the money supply. Seventy percent of corporate bonds are straight discount or coupon bonds with a duration of under five years (includes both guaranteed and nonguaranteed bonds). There is a small but growing number of convertible bonds and bonds with warrants, both guaranteed and nonguaranteed. The major participants in the bond market are institutional investors, mainly securities investment trust companies — analogous to mutual fund management companies in the United States. There are about eight such companies, of which the top three account for most of the business. During 1993, trading in corporate bonds was active while trading in government and public bonds was slow. On at least one occassion, MOF urged institutional investors to buy corporate bonds in an attempt to stabilize market interest rates.

Korean companies, traditionally heavily dependent on indirect financing from banks, are increasingly turning to the securities markets. Direct financing in the securities market exceeded bank financing for the first time in 1988. In 1993, corporations raised 18.9 trillion won ($23.5 billion) through stocks and bonds compared with 1 trillion won ($1.1 billion) in 1980. In 1994, prospects are for a healthy bond market because of increased reliance on overseas financing alternatives, large capital reserves leftover from 1993, and the Bank of Korea's flexible monetary policy. Bond yields are expected to settle near 12 percent for 1994.

Until recently, foreigners were not permitted to purchase Korean bonds. Effective July 1, 1994, foreign investors may purchase nonguaranteed convertible bonds issued by small and medium-sized firms listed on the Korea Stock Exchange, as well as certain state and public sector bonds. At present, foreign investors are permitted to purchase no more than 30 percent of total convertible bonds issued by an individual company. Aggregate foreign ownership in a Korean company through the conversion of convertible bonds is limited to 15 percent of total outstanding shares (including the 10 percent equity limitation, total foreign ownership is limited to 25 percent).

As a result of the second stage of interest rate deregulation, bonds will be issued at market rates. In 1994, 65 trillion won worth of bonds are expected to be issued: 20 trillion worth of government and public bonds, 16 trillion of corporate bonds, 15 trillion of MSBs, and 14 trillion

of financial institution bonds. Total supply is expected to adequately meet the increased demand as a result of the bond market opening to foreigners.

Mutual Funds

Several restrictions limit foreign financial institutions' ability to manage mutual funds. Under the Securities Investment and Trust Business Act, only investment trusts and merchant banks may manage mutual funds. Regulations to the Foreign Capital Inducement Act limit total foreign ownership in an investment trust business to no more than 10 percent, and to no more than 5 percent by a single firm. Although there are no restrictions on foreign participation in merchant banks, under the Merchant Bank Act, merchant banks may only manage funds composed of bonds. On January 1, 1993, foreign investment management companies and investment consulting firms were permitted to open liaison offices and authorized to engage in a limited range of activities. They also were authorized to participate in existing investment management and consulting firms through direct investments.

Established foreign-invested banks may create specified trust accounts on behalf of individual customers, but not mutual funds wherein investors participate by buying shares. Established foreign-invested securities companies may operate fixed-income mutual funds.

Cross-Border Access

Until recently, individual Korean residents were permitted to purchase foreign securities only through an investment trust. Both individual and institutional investors were limited in the aggregate value of securities they could purchase. Only general trading companies and firms whose import and export receipts exceeded $100 million were allowed to purchase foreign securities. In February 1994, however, the government eliminated limits on offshore purchases by institutional investors. Beginning in July 1994, the limits on purchases for individuals were raised to 100 million won ($125,000) and for corporations to 300 million won ($375,000). In addition, the restrictions were removed on the categories of companies permitted to engage in offshore portfolio investments. Stocks, bonds, and beneficiary certificates eligible for offshore purchases are limited to those available on 13 designated stock exchanges.

Although 24 domestic securities firms have received licenses to purchase offshore securities for Korea residents, the Ministry of Finance has declined to issue licenses to foreign securities firms. MOF officials say that the SEA specifically excludes the branches of foreign securities firms in Korea from this licensing privilege. According to the MOF, the volume of this business is small given the current lack of interest among Korean investors in foreign securities.

A number of U.S. and other foreign firms have participated in underwriting Korean securities in offshore markets, and a few have acted as lead managers for such issues. However, the Ministry of Finance tightly regulates the offshore issuance of Korean bonds and equities, and

the role of foreign firms in underwriting new issues is limited. Ministry of Finance approval is required for the offshore issuance of bonds; the number of bond issues approved depends on macroeconomic and balance of payments considerations. Offshore issues of Korean equities are controlled by the Korean Securities Dealers Association (KSDA), which administers a queuing system for the underwriting of issues. The position of securities firms in the queue depends on a scoring system in which firms are awarded higher points if the issuing firm is a small or medium-sized company, or if the funds generated are to be used in high technology applications. The Ministry of Finance also provides informal guidance to the KSDA to regulate the rate of offshore equity issues in light of macroeconomic and balance of payment considerations.

U.S. PRESENCE IN THE MARKET

Entry and Establishment

Article 17-2 of the Enforcement Decree of the SEA permits the establishment of a branch office of a foreign securities firm in Korea subject to certain criteria and with the MOF's approval.

There are 11 branches of foreign securities firms, 26 foreign representative offices, and four joint ventures involving foreign firms. Of these, three of the branches and eight of the representative offices are American. There is no U.S. involvement in the joint ventures.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Current Situation

Under the Foreign Capital Inducement Law, a foreign securities firm may purchase up to 10 percent of a Korean securities company. Total foreign equity in a Korean securities firm may not exceed 50 percent. No U.S. company has purchased equity in a Korean securities company, but three non-U.S. firms had purchased equity in two Korean securities companies as of October 1994. Subsidiaries are not permitted.

In licensing foreign representative offices, the Finance Ministry authorizes only liaison activities, i.e., offices that exchange information with the home office. Representative offices may not engage directly in domestic securities-related business in Korea, including purchases in the stock market. They cannot generate income, including commissions for any of their activities. Representative offices conduct research and perform services, acting as marketing agents for their parent companies. They identify clients for their parent companies and facilitate business with offshore entities in the areas of corporate finance and sales of foreign securities.

Since 1992, the MOF has permitted foreign securities firms to establish branch offices in Korea. The minimum capital requirement varies according to the securities activities the firm wishes to engage in, i.e., dealing, brokerage, or underwriting. The requirement is 10 billion won

($12.5 million) for one category of activity, 15 billion ($18.8 million) for two, and 20 billion ($25 million) for three. A joint venture securities company must have paid-in capital of at least 50 billion won, the same amount required for wholly Korean-owned securities companies. Of the 11 foreign securities companies that have established branches, all but two carry out brokerage activities exclusively. Two firms — Citicorp and Bankers Trust — operate as brokers, dealers, and underwriters.

Korea has partially opened its bond market, as mentioned above in the Description of the Market section, allowing foreign investors to purchase convertible bonds issued by small and medium-sized companies. Foreign investors would have preferred access to convertible bonds of large companies, which are more attractive investments for several reasons. First, sufficient information is not available on the small and medium-sized companies to enable foreign investors to make a decision on purchasing their bonds. Second, foreign investors view small and medium-sized firms as risky investments because of their generally weak financial structure and poor credit ratings. Third, as is the case with stocks, foreign investors as a rule favor large blue-chip bonds over smaller, lesser-known versions.

The Korean government imposes significant restrictions on the ability of foreign firms to engage in the investment trust and investment consulting business through limitations on foreign equity participation.

Foreign firms may not broker transactions involving the acquisition of foreign securities by Korean residents.

Korean resident access to foreign securities products is limited by market and product types, and by ceilings on the amounts that individuals and corporations may purchase.

Foreign firms may not participate in the domestic security over-the-counter market.

No foreign firm has yet to obtain a seat on the Korean Stock Exchange because of the very high cost of exchange seats.

U.S. bankers and securities dealers note that Korean government regulators are moving to address transparency problems, but regulations continue to be ambiguous and subject to varying interpretations. In addition, regulations are sometimes unevenly applied. In the past, new regulations or amendments to existing regulations were often issued without providing sufficient opportunity for public comment. Although the mechanism for publicizing proposed regulations provides only limited scope for soliciting public comment, the Ministry of Finance is making increased efforts to invite the views of foreign firms through organizations such as the American Chamber of Commerce. While welcoming these steps, U.S. firms urge that the government raise the priority of administrative reform and provide more open and transparent procedures for the regulatory changes themselves.

In January 1992, Korea took a significant first step in liberalizing the securities industry by permitting foreign investors to participate directly in the market on a limited basis. Prior to this change, foreigners were limited to investments in Korea only through the Korea Fund, the Korea Europe Fund, or convertible bonds issued offshore by Korean firms. The 1992 liberalization measure parallels the recent easing of restrictions on Korean investment in overseas stock markets, which the Korean government views as necessary to balance capital flows. Nevertheless, foreign participation in the Korean stock market is still limited to 10 percent total foreign ownership and to just 3 percent individual foreign ownership for any stock. As noted previously, the government will lift the ceiling to 12 percent in December, and to 15 percent in 1995 (conditions permitting). There is no such limit on the holdings of shares by Korean residents, although Korean law prohibits corporations from acquiring more than 10 percent ownership in another firm.

Expected Developments

After 1994, according to Korea's blueprint for financial sector liberalization, the government will consider allowing foreign investors to purchase bonds listed in the stock market indirectly, through Korean intermediaries (1995). Subsequently, the purchase of long-term bonds issued by small and medium-sized companies will be allowed (1997). Thus, with the exception of convertible and other bonds issued by small and medium-sized industry and certain state and public bonds, the government has no current plans to open further the bond market to foreign investors, except through bond funds. As with other financial liberalization measures announced, Korea's balance of payments and money supply will influence the decision to increase the securities limits. More than improving conditions for foreign direct investment and providing low cost financing alternatives for domestic companies, the Korean government's principal goal is macroeconomic stability.

Recently, Korea's Finance Minister has indicated the possibility of the following:

- Removal of the ceiling on portfolio investment by foreigners resident in Korea, including locally registered firms and subsidiaries (January 1, 1995);

- Loosening of the restrictions on foreign purchases of stocks in listed JV companies (January 1, 1995);

- Authorization of foreign purchases of Korean bonds through investment trusts and mutual funds (during 1995);

- "Unspecified" measures to encourage outward portfolio investment by Korean residents; and,

- "Review" of a plan to allow the stocks of foreign firms to be listed on the KSE.

FINANCIAL MARKET DISCUSSIONS/FINANCIAL POLICY TALKS

In its bilateral financial policy talks and in Uruguay Round negotiations with the Korean Ministry of Finance, the U.S. Treasury Department has sought to broaden market access and achieve national treatment for foreign financial institutions, including U.S. securities firms.

Foreign securities firms unanimously agree that the single most important issue for them is obtaining the Finance Ministry's approval to expand the existing stock purchase quota. Foreign securities firms depend heavily on the opening of the equity market to ensure the viability of their branch operations which are subject to costly and discriminatory capital requirements. More than 200 listed companies are at the 10 percent ownership limit already, and another 200 companies are above 9 percent. The Treasury Department has taken the lead in pressing Korea to raise the stock ownership ceiling through the financial policy talks — stressing that continued delay risked losing investor confidence in the reform program. As noted previously, the government has recently announced that, effective December 1, 1994, the ceiling will be raised to 12 percent. The Ministry of Finance has also pledged to raise the ceiling to 15 percent during 1995, conditions permitting. The Treasury Department will remain closely engaged on this issue and will urge the Ministry of Finance to accelerate the opening of the stock market to foreign investors.

The licensing and capitalization requirements for branches of foreign securities firms in Korea are generally more onerous than international standards. The amount required for each separate business license (brokering, dealing, and underwriting) is well above normal business requirements. Foreign brokers argue that the parent company's capitalization and support should be factored into the capital requirements placed on individual branches. Korea's Blueprint for financial sector liberalization makes only vague reference to capitalization concerns by noting that they will be eased in the 1996-97 timeframe. In general, Korean regulators have argued that to ensure regulatory control, foreign financial institutions must capitalize locally. The Treasury Department considers current capitalization requirements to be a serious concern, and will continue to press the MOF, both bilaterally and in the continuing Uruguay Round negotiations, for progress in this area.

Finally, introduction of new products by foreign securities firms is limited by foreign exchange regulations that restrict capital inflows and outflows. Although the Ministry of Finance did concede in 1992 to allow foreign securities branches to hedge their operating capital, Korea's extensive capital controls continue to impact foreign securities firms considerably more so than domestic firms due to the cross-border nature of foreign firms' business.

Exchange Rates

1991 End of year	$1 = 760.8 W
1991 Average	$1 = 733.4 W
1992 End of year	$1 = 788.4 W
1992 Average	$1 = 780.7 W
1993 End of year	$1 = 808.1 W
1993 Average	$1 = 802.7 W

MALAYSIA

BANKING

SUMMARY

Stimulated by successive years of high real economic growth, the Malaysian banking industry has grown steadily. From 1983 to 1993, total assets of the banking system (including assets of the central bank, Bank Negara Malaysia) increased by an average 14 percent annually in domestic currency terms to reach RM248 billion ($97 billion) by June 1993. The industry is dominated by a small number of domestic institutions in which the federal government or quasi-government entities are major shareholders.

As of June 30, 1994, there were 14 foreign bank branches operating in Malaysia out of a total of 37 commercial banks in the country. The foreign banks have a sizable share of the banking market, with approximately 25 percent of the industry's assets.

However, Malaysia has issued no new commercial banking licenses, except those restricted to offshore activities, since 1982. Acquisition of existing domestic banks is not a viable option for foreign banks. Individual ownership in domestic banks is limited to 10 percent for an individual and 20 percent for others, with an aggregate cap on total foreign investment in any one entity limited to 30 percent. Moreover, a 1989 law mandated that the 14 existing foreign bank branches be converted into locally incorporated institutions by September 1994. Although the Malaysian government has agreed to permit continued 100 foreign ownership of these foreign banks, this requirement imposes sizable additional costs on them.

In addition to the limitations on entry and the "forced" incorporation requirement, there are important other restrictions on expansion and operation by foreign banks. For example, unlike domestic banks, foreign commercial banks may not establish new branches. Moreover, offsite automatic teller machines are considered to be branches, which effectively keeps foreign banks out of the ATM market and impedes their ability to attract depositors. In addition, foreign banks are restricted to providing no more than 40 percent of the domestic borrowing by foreign companies.

Foreign controlled banks are afforded the same treatment as domestic banks with regard to money market instruments, access to the Central Bank discount window, and the bringing of capital into Malaysia from offshore via swaps. Although there are generally transparent rules governing Malaysian financial and capital markets, the substantial discretionary powers of the financial authorities creates a degree of uncertainty when approval is required for certain transactions. Foreign financial institutions are given the opportunity to comment on proposed changes and are notified of regulatory changes.

As of June 30, 1994, four U.S. banks held full commercial licenses in Malaysia: Bank of America (Security Pacific Asian Bank since 1957), Citibank — three branches (since 1959),

Bank of America — one branch (since 1959), and Chase Manhattan Bank — one branch (since 1964). Of these, only Citibank has multiple branches. The number of U.S. banks with a Malaysian presence dropped to three in August 1994, following the sale of Security Pacific Asian Bank to a Malaysian entity.

DESCRIPTION OF THE MARKET

Malaysia is a rapidly developing nation of some 19 million people with 1993 gross domestic product equal to about $65 billion. Much of its recent high real economic growth has been generated by foreign investment in manufacturing. The rise of manufacturing's share in national output, currently about 30 percent, and the influx of foreign firms into Malaysia have been major stimuli to the development of the country's domestic commercial banking sector.

The banking industry is dominated by a small number of domestic deposit-taking institutions in which the federal government and quasi-government entities are significant shareholders. The top five domestic banks hold slightly over one-half of total commercial bank assets (52 percent). Government-owned Bank Bumiputra Malaysia Berhad, together with Maybank Berhad (publicly listed, but effectively controlled by the government) account for almost one-third of all banking assets between them. (See the accompanying table.)

Commercial banks

As of June 30, 1993, a total of 37 commercial banks with 1,164 branches throughout peninsular Malaysia and the east Malaysia states of Sarawak and Sabah had commercial banking licenses. Total assets of commercial banks were RM186 billion ($73 billion at the then-current exchange rate), 75 percent of which were held by domestically controlled banks, many of which have some foreign participation.

Foreign Banks

When Malaysia gained its independence, foreign banks controlled the industry, accounting for 89 percent of all bank offices. Almost all foreign commercial banks currently in the country established their presence as branch banks of an overseas bank before or shortly after Malaysia reached independence. Among the foreign branch banks, three of the so-called "colonial banks" (Hongkong and Shanghai Banking Corp., Oversea-Chinese Banking Corp., and Standard Chartered Bank) hold 52 percent of the RM46 billion ($18 billion) of foreign-owned assets. In fiscal year 1993, foreign banks earned 45 percent of total pre-tax profits in the banking sector, and held 50.9 percent of net working funds/paid-in capital at the end of 1993.

Finance Companies

After banks, the next most important financial intermediaries are the country's 40 finance companies, of which four are 100 percent foreign-controlled. Seven have at least some foreign equity participation. Having suffered losses from real estate and stock market lending during the Malaysian recession of 1985-86, this sector underwent a period of consolidation during which seven institutions were absorbed by stronger finance companies or, in one case, by a commercial bank. Finance companies primarily make small loans: 78 percent of their loans are for less than RM500,000 ($185,000). Particular areas of strength for finance companies are auto loans (where they have a substantial portion of the market) and home mortgages.

As with the commercial banking industry, the finance company industry is concentrated. The three largest firms holding 47 percent of the sector's assets. The most recent finance company licenses were awarded in 1984.

Merchant Banks

The third most important deposit-taking institutions in Malaysia are the 12 merchant banks, nine of which have some foreign equity participation. In the wake of liberalizing regulations promulgated in 1991, merchant banks can accept fixed deposits with a minimum one-month maturity in amounts not less than RM200,000 ($74,000). They can hold shares on their own account in companies listed on a Malaysian exchange. In addition, they may underwrite private debt securities and, with prior permission from the central bank, they may underwrite foreign securities. Most merchant bank term lending (69 percent) is in the form of loans of less than five years.

Regulation

On February 1, 1991, the "base lending rate" (BLR — akin to the U.S. prime rate) of commercial banks was freed from the central bank's (Bank Negara) direct administrative control. Banks now compute the BLR on a monthly basis using a four-element formula comprising cost of funds, staff costs, overhead, and a 0.25 percentage point spread. The maximum interest rate that banks can charge is the BLR plus a spread not to exceed four percentage points. Deposit rates are market-determined. The chief types of deposits are demand deposits in the form of non-interest bearing checking accounts, time deposit savings in the form of passbook accounts, and certificates of deposit.

Bank Negara sets lending guidelines that target certain groups and sectors of the economy — such as the Bumiputra community (ethnic Malay and indigenous people) — small businesses, and low-cost residential real estate. In 1992, lending guidelines required banks to extend 20 percent of their loans to Bumiputras.

Another policy priority of Bank Negara is the establishment of a viable international offshore financial center (IOFC) on the island of Labuan, off the coast of Sabah. Since the formal establishment of the IOFC on October 1, 1990, the Ministry of Finance has awarded 31 bank licenses (including two licenses to U.S. banks) and given three offshore insurance licenses. The registrar of companies has approved 11 trust companies to conduct business in Labuan. According to Bank Negara, "Labuan has imposed strict rules of confidentiality on shareholders, management, and general information about companies registered in the territory or accounts in the territory's banks."

Islamic Banking

Since 1983, Bank Negara has fostered the development of an Islamic banking system. Rather than paying interest on deposits, Islamic banks may provide depositors with a share of the bank's profits. This same principle applies to borrowing, with the lending bank receiving a percentage of the borrower's profit.

Islamic banking is still relatively small (total assets of less than $1.0 billion). It is dominated by Bank Islam Malaysia, the country's only fully Islamic financial institution. In March 1993, a number of other financial institutions were permitted (and encouraged) to offer Islamic banking services through their existing branches. As of December 1993, 20 had done so, including one foreign commercial bank.

In January 1994, the government instituted an Islamic interbank market for trading financial instruments and investments, as well as for clearing checks.

Deposit Insurance

There is no government or privately sponsored system of deposit insurance in Malaysia.

U.S. PRESENCE IN THE MARKET

As of June 30, 1994, four U.S. commercial banks were licensed to operate in Malaysia. All four entered as branches. The largest U.S. bank in Malaysia is Citibank N.A. (licensed since 1959) with three branches and assets, as of June 1993, of RM5.2 billion (US$1.9 billion). Bank of America N.T. & S.A. (also licensed since 1959) has a single branch and assets of RM1.4 billion ($510 million). Chase Manhattan Bank N.A. (licensed 1964) has a single branch and assets of RM880 million ($320 million). Citibank and Bank of America serve both the retail and the corporate markets. Chase Manhattan serves primarily corporate clients.

The fourth U.S. bank, Security Pacific Asian Bank Limited, was under Bank of America's ownership. Because of restrictions on the opening of new branches by foreign-owned banks,

Bank of America had no alternative but to sell Security Pacific Malaysia to a Malaysian entity, Arab Malaysian Bank Berhad.

There are no U.S. finance companies or merchant banks in Malaysia. Two U.S. banks, Chemical Bank and Bank of California, maintain representative offices in Kuala Lumpur.

Excluding Security Pacific Asian Bank, U.S. banks hold 17 percent of the foreign-controlled commercial bank assets in Malaysia, a percentage that has been relatively stable for the last 15 years.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since no new bank licenses are being awarded outside of the Labuan IOFC, the only means of entry into the Malaysian banking market, other than through a representative office, is through the purchase of an existing institution. Under current Malaysian law, the maximum permissible shareholding in a licensed institution is 10 percent for an individual (domestic and foreign) and 20 percent for entities other than an individual. Aggregate foreign shareholding allowed in a licensed banking institution is 30 percent. In addition, the Banking and Financial Institutions Act of 1989 required that all existing foreign bank branches to incorporate locally by September 1994. While the Malaysian government has committed itself to permitting continued 100 foreign ownership in these entities, the incorporation requirement will involve increased costs for foreign banks and will result in a less efficient form of organization. A question has also arisen over the implications of the change on the transfer of information between the foreign parent and its Malaysian subsidiary. Branches of foreign banks were exempt from a clause in Malaysian law that precludes banks from sharing credit information with their foreign parents. Monetary authorities have yet to issue instructions that would allow Malaysian subsidiaries to continue to share information automatically with their controlling parents. However, Bank Negara has provided assurances to the U.S. Embassy in Malaysia that they intend to do so through the issuance of individual exemptions to each foreign-controlled subsidiary.

In addition, U.S. banks (and all other foreign banks) face discriminatory treatment with respect to expansion and operations. All resident companies that are majority foreign-owned are required to source at least 60 percent of their domestic credit needs with a Malaysian-owned bank. Foreign-controlled companies are estimated to comprise 10 percent of the total market for domestic banking credit. These companies tend to be natural customers for foreign banks.

Foreign banks, unlike domestic banks, are prohibited from establishing new branches. This severely constrains the ability of U.S. banks to attract depositors. Moreover, for regulatory purposes, any offsite automatic teller machine is considered to be a separate branch, preventing U.S. banks from offering the same range of services as their domestic competitors. These restrictions will not be alleviated by the local incorporation of existing branches, as they apply to all banks with more than 50 percent foreign ownership.

U.S. financial institutions also are adversely affected by limits on cross-border movement of persons through immigration regulations. The number of expatriate employees is generally restricted to two per bank, making it difficult for foreign banks to bring expatriate managerial talent into the country. Recently, there has been some relaxation of these restrictions to allow for intracorporate exchanges and short-term project assignments. It should be noted that domestic banks are subjected to even more stringent restrictions on hiring expatriates.

Foreign banks are afforded the same treatment as domestic banks with regard to money market instruments, access to the Central Bank discount window, and bringing in capital from offshore via swaps. Although there are generally transparent rules governing Malaysian financial and capital markets, the substantial discretionary power of the financial authorities creates a degree of uncertainty when approval is required for certain transactions. Foreign financial institutions are given the opportunity to comment beforehand and are notified of regulatory changes.

Malaysian Banking System
Assets and Liabilities, October 1993
(RM billions)

	Commercial Banks	Finance Companies	Merchant Banks
Assets			
Cash	1.0	0.1	0.0
Central Bank	7.6	3.6	0.8
Amounts Due	43.8	-	-
Securities	16.5	1.9	1.2
Loans	113.4	42.6	8.8
Other	20.6	13.1	7.0
Total	**202.9**	**61.3**	**17.8**
Liabilities			
Capital	9.1	3.1	0.9
Amounts Due	25.8	-	-
Deposits	112.2	45.3	10.0
Other	55.8	12.9	6.8
Total	**202.9**	**61.3**	**17.8**

Source: Money and Banking in Malaysia, Jan. 1994.
Note: Deposits do not include negotiable certificates of deposit.

Commercial Banks in Malaysia
June 30, 1993

	Start-Up Year	Assets (RM million)	Branches
Malaysian Banks			
Ban Hin Lee Bank	1935	2,505	27
Bank Bumiputra Malaysia	1966	25,413	156
Bank Buruh	1975	1,025	4
Bank of Commerce	1973	8,283	41
Bank Utama	1976	2,141	17
Development & Commercial	1966	11,663	49
Econ Bank	1964	632	11
Hock Hua Bank	1951	2,369	23
Hock Hua (Sabah)	1961	520	5
Kwong Yik Bank	1913	4,365	50
Maybank	1960	34,634	213
Malaysian French Bank	1982	2,238	22
Mui Bank	1923	2,782	35
Oriental bank	1937	2,957	23
Perwira Habib Bank	1976	5,786	44
Public Bank	1966	15,206	121
Sabah Bank	1979	1,277	15
Southern Bank	1965	2,828	49
The Pacific Bank	1922	2,617	28
UMBC	1960	10,375	73
WahTat Bank	1955	361	12
Subtotal		**139,977**	**1,018**
Foreign Banks			
ABN Amro Bank	1888	798	2
Bangkok Bank	1959	582	1
Bank of America	1959	1,387	1
Chung Kiaw Bank	1951	4,008	16
Citibank	1959	5,176	3
Duetsche Bank	1968	1,395	1
Lee Wah Bank	1956	2,959	9
OCBC Ltd.	1932	5,895	25
Overseas Union Bank	1958	1,710	12
Security Pacific AS	1957	427	1
Standard Chartered	1875	8,448	35
The Bank of Nova Scotia	1973	1,016	1
The Bank of Tokyo	1959	1,713	1
The Chase Manhattan Bank	1964	884	1
Hong Kong & Shanghai Bank	1884	9,265	36
United Oversease Bank	1966	141	1
Subtotal		**45,803**	**146**
Total		**185,785**	**1,164**

Source: Money and Banking in Malaysia, Jan 1994.

MALAYSIA

SECURITIES

SUMMARY

From its 19th-century colonial roots and early trading in shares of rubber and tin companies, the Malaysian securities market has grown substantially. In the 1980s, issuance of federal government securities was the main source of Malaysian capital market expansion, accounting for about three-fourths of net funds raised. Following the central government's 1986 policy of privatizing para-statal enterprises, stock offerings of public sector corporations, such as the national airline, telecommunications company, and electric utility company, were the prime sources of development for the Kuala Lumpur Stock Exchange (KLSE).

An emerging market in private, fixed-income instruments, the expansion of which is a major government monetary policy objective, has been stimulated by regulatory reform and a high domestic savings rate. The market for Malaysian Federal government securities remains dominated by the Employees Provident Fund (EPF), the country's forced-contribution retirement system.

In addition to markets in corporate equity and debt, Malaysia has a largely dormant commodities futures market, which trades futures contracts in rubber, palm oil, and tin. The government has approved the establishment of two exchanges for financial futures and derivatives, but neither has yet begun trading. There also is a modest Bumiputra Stock Exchange (BSE) for equity issues limited to ethnic Malays.

Foreign membership in the Kuala Lumpur Stock Exchange (KLSE) is limited to ownership of an aggregate total of 49 percent of paid-up capital of an existing member firm, with each foreign participant limited to a 10 percent share. Currently, several foreign brokers own a 30 percent share of various stockbroking firms in Malaysia. They may apply for up to 49-percent participation. Foreign firms are permitted to register as investment advisers and to conduct market research for overseas clients.

As a result of significant restrictions on market entry, no U.S. securities firms operate in Malaysia. U.S. companies interested in Malaysian portfolio investment for their own account or for their clients generally operate through their subsidiaries in neighboring locations, such as Hong Kong and Singapore.

DESCRIPTION OF THE MARKET

Regulatory Regime

On March 1, 1993, the Malaysian Securities Commission (SC) assumed regulatory responsibilities that had been distributed over a number of government bodies. In addition to

the securities industry, the SC regulates property trust schemes, takeovers and mergers of companies, and unit trusts. Once the Kuala Lumpur Futures Market (KLFM) and the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) begin operations, possibly by the end of 1994, the SC will regulate these markets also.

In addition to the SC, four other agencies participate in the regulation of the securities industry. The KLSE is a self-regulatory, private sector organization. The registrar of companies (ROC), an arm of the Ministry of Domestic Trade and Consumer Affairs, and the licensing officer (LO) of the Ministry of Finance administer the Companies Act of 1965 and certain provisions of the Securities Act of 1983 (the latter is a re-enactment of the Securities Industries Act of 1973). Finally, the Foreign Investment Committee (FIC), chaired by the Director of the Economic Planning Unit of the Prime Minister's Department, implements guidelines on acquisition of assets, mergers or takeovers of companies, and foreign investment.

With the exception of the stock market, Malaysia's capital market is still in its infancy, and consequently, there is a shortage of regulatory coverage and authority for new instruments that could help deepen the market. Although the government of Malaysia is keen to introduce new financial products to enhance development, adjustment problems have slowed progress. Even the long awaited start-up of trading in a stock index by the Kuala Lumpur Options Financial Futures Exchange (KLOFFE) (set up by four domestic corporations, of which two are financial corporations) has yet to materialize. Substantial delays have also been experienced in obtaining SC approvals for corporate restructurings.

The Bond Market

There are no restrictions on the types of instruments that may be offered in Malaysia's bond market. In terms of tradeable bonds on the secondary market, Malaysian government issues, known as Malaysian Government Securities (MGSs), along with shorter-term Treasury bills, dominate. The central bank, Bank Negara, also has recently started issuing short-term Negara bills as a means of exerting more monetary control. Other tradeable bonds are fixed interest corporate issues listed on the Kuala Lumpur Stock Exchange (KLSE) (including fixed-rate straight bonds, convertible redeemable bonds, and convertible irredeemable bonds) and Cagamas bonds (explained below).

The domestic bond market in Malaysia began in 1986 with Bank Negara's (the central bank) establishment of Cagamas Berhad, a government corporation that issues mortgage-backed securities (these are corporate issues known as Cagamas bonds). That same year, government borrowing peaked at 111 percent of GNP. Strong growth in the economy (an average annual increase in GDP of 8.2 percent between 1987 and 1993) has enabled the government to reduce external borrowings by prepaying some foreign loans with domestic financing, thereby improving the liquidity of MGBs. Related growth in tax revenues and the profitability of government-sponsored corporations (the nonfinancial public enterprises, or NFPEs), on the other

hand, has also permitted steady reduction of domestic government borrowing, to 69 percent of GNP in 1993. Therefore, after a subsequent flurry of activity and a relatively active secondary market, trading in Cagamas bonds fell to a total turnover of only RM1.6 billion ($432 million) in 1992. New issues of Malayasian Federal GOvernment bonds totalled RM 2.8 billion in 1993.

The expansion of the nascent market in fixed- and floating-rate corporate debt has been a major policy objective of the federal government. In 1989, with the intent of lowering the relative transactions cost of private debt, the government exempted the issuance and trading of corporate bonds from the country's 0.5 percent stamp duty. Subsequently, interest income to individual investors from nonconvertible bonds was exempted from income tax. In 1990, the central bank encouraged the establishment of the Rating Agency of Malaysia (RAM) to provide credit ratings of firms issuing bonds and commercial paper and to provide potential investors with the necessary financial information on which to base investment decisions.

Malaysia's primary and secondary debt markets remain small. At the end of 1993, the stock of outstanding corporate debt stood at about RM 9.0 billion ($3.3 billion), almost double the stock of Cagamas bonds and about 14 percent of the value of outstanding MGSs. New issues in the corporate bond market in 1993 totalled RM 3.1 billion, consisting of RM 804 million in debentures, RM 1.7 billion in mortgage bond issues, and RM 677 million in promissory notes (conventional bonds, convertible bonds, and Islamic notes). Some 30 issues are publicly traded, but the market is illiquid.

Malaysian Government Securities by Holder
(RM millions)

Holder	1991 (12/31)	1992 (12/31)	1993 (6/30)
Public Sector			
Government	5,790	5,237	5,237
Social Security	41,991	44,472	44,864
Central Bank	1,260	336	330
National Savings Bank	1,601	1,867	1,919
Subtotal	50,562	51,912	52,350
Private Sector			
Commercial Banks	8,496	8,680	8,206
Other[1]	6,205	6,051	5,263
Subtotal	14,701	14,731	13,469
Total	65,263	66,643	65,819

[1]Includes finance companies, merchant banks, discount houses, and certain quasi-private nonbank financial firms.
Source: Money and Banking in Malaysia, January 1994.

The market in government debt is dominated by the Employees Provident Fund (EPF, Malaysia's forced-contribution retirement system), which is statutorily required to invest half of its annual capital inflow and to hold 70 percent of its stock of assets in MGSs. By mid-1993, EPF and other public sector social security organizations owned over two-thirds of the stock of outstanding government securities.

Designated principal dealers underwrite government primary issues (MGSs, T-bills, Negara bills, and Cagamas bonds) and provide two-way quotations for the secondary market. Principals or approved dealers consist of commercial banks, merchant banks, discount houses and finance companies. Financial institutions are designated as principal dealers based on their individual volumes of bond activities. Branches of foreign commercial banks are included among principal dealers; none is American, however. The Scripless Securities Trading System (SSTS), introduced on January 1, 1990, conducts trades.

The Equity Market

The Kuala Lumpur Stock Exchange (KLSE) was founded in July 1973 as a result of a bifurcation created between the Malaysian and Singapore stock markets. The KLSE's most rapid development has occurred since October 1989, after the Finance Minister prohibited firms incorporated in Malaysia from cross-listing on the Singapore exchange. As of end-1993, first board companies numbered 329, and second board companies, 84, bringing total listings on the KLSE to 413. Trading on the KLSE has been quite active in recent times: on some days the volume is higher in Kuala Lumpur than on the New York exchanges. The conversion of trading from an open-outcry to an electronic system in 1989, and then to a fully automatic computerized order and execution system at the end of 1992, provided the KLSE with the capability to cope with just such an increase in volume.

The central government's "privatization" program, consisting of a limited number of large offerings, has been an important driving force behind the marked increase in KLSE liquidity in recent years. For example, the initial share issue in Telekom Malaysia, the national telecommunications firm, accounted for over a quarter of net funds raised on the KLSE in 1990. In 1992, three government stock offerings were responsible for nearly one-half of the exchange's net capital increase. Although the general public (both foreign and domestic) holds shares in these firms, the largest shareholders in these firms are government and quasi-government institutions, in particular the Ministry of Finance. In terms of market capitalization, these privatized firms remain by far the largest of the 439 issues listed on the KLSE as of end-August 1994.

Other factors behind the KLSE's strong performance and high turnover include impressive economic growth, good corporate earnings, a reasonable level of inflation, falling interest rates, the absence of capital gains taxes on shares transactions and rising liquidity in domestic financial

markets. Keen interest among foreign investors in emerging markets equities has also played a major role.

The KLSE operates a call market system though SCORE (System on Computerized Order Routing and Execution). The Securities Clearing Automated Network Services Sdn Bhd (SCANS), founded in 1983, is a wholly-owned subsidiary of KLSE that provides clearing operations. The business of dealing is carried out by member companies.

Member companies are stockbroking houses. The members of the KLSE are either natural persons or corporations who are the shareholders of the member companies. To be eligible to apply for a corporate membership on the KLSE, at least 51 percent of the equity of a company with shareholders' funds of over RM 100 million ($38.5 million), or a minimum amount as approved by the Finance Minister, must be held by a local corporation. Bank Negara no longer issues new stockbroking firm licenses except for towns that have no stockbroking firm. The issuance of new licenses is limited to local corporations only.

Institutional participation is rising; important institutional participants include the unit trust funds (there are 40 open-ended funds in Malaysia), the Employee Provident Fund (national pension fund), the Ministry of Finance, Inc., the Armed Forces Superannuated Fund, and foreign entities.

Foreign corporate ownership of member firms, which had been limited to 30 percent, was increased to an aggregate total of 49 percent of paid-up capital of an existing member company in July 1988. A member company with foreign participation is treated no differently than other member companies. Currently, there are 11 member companies in which foreigners have an interest. No U.S. firms currently hold equity in a KLSE stockbroking firm, although several are said to be exploring the possibility.

After several years of steady improvement, the KLSE had a banner year in 1993. Total turnover surpassed the cumulative total value and volume of shares traded over the previous 20 years. By end-1993, total capitalization had risen to RM 619.6 billion ($230 billion), making Malaysia's the largest stock market in Southeast Asia. The largest 20 companies accounted for 41 percent of capitalization.[1] The KLSE Composite Index[2] hit a record high of 1275.32 at year-end. New issues actually peaked in 1992, at MR 5,490 million, then fell sharply last year to RM 691 million.

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[1] As the second largest single component of stock market capitalization (after utilities companies), companies of the casino and gaming industry are overrepresented within the top twenty companies, particularly relative to their importance in overall economic activity. The timber and petroleum industries are underrepresented.

[2] The Benchmark Index comprises 85 stocks, which account for approximately 51 percent of total market capitalization.

The surge in trading in 1993 reflected both the purchase of equities by local and foreign fund managers anticipating improved market performance and a substantial increase in short-term trading. In addition, a type of speculative activity know as contra trading (which does not require physical delivery of shares before a sale is processed) generated one-third of average daily volume in 1993. Contra trading, in combination with other speculative deals such as reverse takeovers and backdoor listings, is thought to have contributed to overheating on the KLSE last year.

The SC has indicated that going forward, it will supervise the market more carefully and apply existing regulations more stringently. Comparatively lackluster trading volumes and share price appreciation are already evident in 1994, with the KLSE Composite Index dropping almost 30 percent during the first quarter of the year. Earlier in 1994 the SC placed restrictions on reverse takeovers and backdoor listings and expanded its scope to oversee cash transactions, disposals and de-mergers, in an effort to curb speculative trading. Apart from consolidation of investments in response to regulatory tightening, concern about accelerating inflation and higher interest rates to contain it may well dampen appetites for equity. The uncertainty surrounding a possible election later this year also could depress activity, in view of the historically positive correlation between elections, stock exchange liquidity and share prices. Nevertheless, the KLSE will remain an important source of long term funding for domestic corporations.

Fund Management

The establishment of a fund management company requires a license from the licensing officer of the Ministry of Finance. In order to manage funds (unit trusts, mutual funds, or pension funds) securities companies or banks must set up a separate subsidiary. With regard to unit trusts or mutual fund companies, foreign fund managers are limited to an equity stake of 30 percent and the remaining 70 percent of equity must be owned by Malaysians, of which 30 percent must be owned by Bumiputras. Liberalization of local unit trust legislation has allowed unit trusts to invest in a broader range of stock, and the per unit trust fund overall limit also has been increased.

Foreign banks and securities firms are allowed to engage in fund management activities in the same way as local banks and securities firms. Some of the largest domestic institutional and pension funds seek the expertise of foreign funds to provide management services. Several foreign financial services firms are now working on setting-up fund management offices in Kuala Lumpur.

However, because of the equity participation limit imposed by the government, for the most part foreign fund managers have chosen to operate offshore, mostly in Singapore. They usually have a representative office or research office in Kuala Lumpur. There are no new legal impediments to the cross-border provision of their services.

Cross-Border Capital Controls

Malaysia has an open foreign exchange regime. Payments, including the repatriation of capital and remittance of profits, are freely permitted and are transacted on a timely basis. Repatriation of proceeds from investment for amounts in excess of RM 50,000 requires the completion of exchange control forms, however. No cross-border restrictions are imposed on foreign portfolio investment flows. Provided that domestic credit is not involved, Malay residents do not need to obtain permission for direct and portfolio investment abroad (except for investments in Israel, Serbia, and Montenegro). Residents using domestic credit to invest abroad must obtain prior approval from the Controller of Foreign Exchange.

U.S. PRESENCE IN THE MARKET

No U.S. securities firm is licensed to operate in Malaysia as a branch, as a wholly-owned subsidiary, or as a joint venture. At least one U.S. firm is active in the market as a minority partner in a firm that structures capital financing for local clients.

No U.S. investors currently hold shares in companies that are members of the KLSE, although several are reportedly exploring the possibility of minority participation. No U.S. firms are designated as principal dealers in the government bond market; U.S. banks are approved dealers, however.

According to official sources, no U.S. securities firm has applied to operate in Malaysia either as a branch or as a joint venture with other stockbroking firms. Of the 59 member companies, there are currently 11 stockbroking firms with a foreign ownership interest. In addition, there are also more than 20 representative officers of foreign stockbroking firms and 79 country and investment funds in Malaysia.

U.S. firms may participate in underwriting on a cross-border basis only if the underwriting is not denominated in Malaysian ringgits. Large entities, though, issue Euro-bonds (some RM 138 billion is expected to be raised by the end of 1994), so U.S. firms have an opportunity to compete for a portion of the underwriting business.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

With regard to foreign ownership of Malaysian incorporated companies, prior approval of the Foreign Investment Committee is required for any purchases of 15 percent or more of the voting stock by non-Malaysians, any purchase above MR 5 million by any investor (foreign or domestic), and any purchases that will result in the aggregate ownership of a company amounting to 30 percent or more.

While there are no restrictions on foreign firms trading in the corporate debt market, foreign purchases of government debt are limited to Negara bills, T-bills, and MGSs (as of August 1994). Foreign firms may not purchase Cagamas bonds.

U.S. firms face substantial impediments in the Malaysian equities market, including limitations on investment in KLSE-listed companies, barriers to obtaining brokerage licenses, and uncertainty regarding regulatory approvals. These and other problems are discussed below.

Foreign ownership of a KLSE member firm is restricted to a maximum 30 percent share holding, although exceptions allowing for up to 49 percent participation are possible if a positive contribution to the local stockbroking industry can be demonstrated.

Currently, several foreign brokers own a 30 percent share of stockbroking firms in Malaysia. Exceptions allowing for up to 49 percent participation are possible. New licenses for joint venture (30 percent foreign) securities firms providing broking and underwriting services are subject to an economic needs test. At this juncture, no new brokerage license approvals are anticipated.

Although there are generally transparent rules governing Malaysian financial and capital markets, the financial authorities maintain substantial discretionary authority when approval is required for certain transactions. Foreign financial institutions are treated no differently from domestic financial institutions vis-a-vis opportunities to comment on, and be notified of, regulatory changes.

ISLAMIC REPUBLIC OF PAKISTAN

BANKING

SUMMARY

The banking sector in the Islamic Republic of Pakistan has been long dominated by nationalized state-owned banks. However, there has been some liberalization in the wake of financial reforms introduced in recent years. Currently, there are 20 Pakistani commercial banks with over 7,600 branches nationwide. Four of these 20 banks are state-owned; they account for over 70 percent of total commercial bank assets.

In addition, there are 21 foreign commercial banks doing business in Pakistan with 71 branches. Foreign banks are permitted to engage in a full range of banking activities. The major impediment facing individual foreign banks has been the inability to establish more than four branches nationwide. However, in mid-1994, Citibank received authorization to establish additional branches. This was the first instance of a foreign bank receiving permission to do so. No foreign bank has yet to establish as a subsidiary.

In addition, foreign banks are subject to a higher withholding tax and more vigorous application of regulatory requirements than domestic banks. However, unlike their state-owned and private sector competitors, foreign banks are not subject to requirements to lend to designated sectors of the economy, nor are they pressured to provide loans to politically popular projects or borrowers. As a result, they have been able to avoid the poor loan problems that have plagued the rest of the Pakistani banking community.

Four U.S. banks currently have branches operating in Pakistan. One U.S. bank is in the process of discontinuing its retail operations, but it intends to remain in wholesale banking. The other three banks have been highly profitable. Citibank is the largest foreign bank in Pakistan.

Considerable liberalization of financial markets in recent years has improved the business climate. A case pending before the Supreme Court, however, could result in a requirement to bring the financial system into conformity with Islamic economic principles that would outlaw all forms of interest. This action could have a significant impact on the operations of U.S. banks in Pakistan.

DESCRIPTION OF THE MARKET

The banking sector in the Islamic Republic of Pakistan for the past 20 years has been dominated by nationalized banks. All Pakistani banks were nationalized on January 1, 1974. (The two foreign banks in operation at the time, neither of which was American, were not nationalized.) However, in a change in policy in December 1990, the government announced plans to begin privatizing state-owned banks and to allow the establishment of private domestic banks. By the

end of 1993, two formerly nationalized banks had been privatized and 14 new private banks had been granted licenses by the State Bank of Pakistan.

However, as can be seen from the accompanying table, the state-owned banks still dominate the banking sector in Pakistan. The assets of the three largest state-owned banks account for almost 70 percent of all banking assets. In addition to the two state-owned banks that Pakistan has already privatized, the government has announced plans to also privatize the Habib Bank and the United Bank Ltd. in the future. Foreign banks make up a small, but growing share of the banking industry.

Assets and liabilities of the banking sector, disaggregated for the four state-owned banks, all foreign banks, individual U.S. banks, and newly privatized Pakistani banks, are shown in the first table. These data are for the fourth quarter of 1992, the most recent date for which such detailed data are available, and are in millions of rupees.

Assets and Deposits of Selected Banks

	Assets	Deposits
All Foreign Banks	140,527	73,728
U.S. Banks	56,821	33,096
Citibank	30,098	18,166
American Express	13,475	7,435
Bank of America	10,495	6,233
Chase	2,753	1,262
State-Owned Banks	612,194	361,499
Habib Bank	276,726	144,358
National Bank of Pakistan	199,993	128,678
United Bank Ltd.	134,213	87,482
First Women Bank	1,262	981
Newly Privatized Banks	131,853	83,770
Muslim Commercial Bank	77,529	50,014
Allied Bank	54,324	33,756

Source: State Bank of Pakistan and bank annual reports.

Commercial banks in Pakistan are engaged primarily in corporate lending and, for the state-owned banks and newly privatized banks, various forms of concessionary lending. Consumer banking in Pakistan is largely undeveloped.

Total bank deposits, assets/liabilities, and branches for domestic and foreign banks, as of June 1993, are shown in the following table.

Total Bank Deposits, Assets and Liabilities, and Branches
June 1993
(billions of rupees)

	Pakistani Banks	Foreign Banks	Total
Bank Deposits	385.4	87.5	472.9
(percent)	(81.5)	(18.5)	(100.0)
Total Assets/Liabilities	913.7	232.5	1,146.2
(percent)	(79.7)	(20.3)	(100.0)
Branches	7,685	71	7,756
(percent)	(99.1)	(0.9)	(100.0)

Source: State Bank of Pakistan

Bank Deposits

	Pakistani	Foreign	Total	Foreign/ Total
1992	318,981	74,340	393,321	18.9%
1990	206,534	42,348	248,882	17.0%
1988	184,574	26,347	210,921	12.5%
1986	149,670	18,082	169,753	10.8%

Government Regulation

The government has pursued a policy of prescribing target levels of lending to certain sectors of the economy to ensure that these priority sectors receive sufficient credit. These credit targets apply only to state-owned banks. In 1993, the target sectors were agriculture, small scale agriculture (plots of land that allow for no more than "subsistence" farming), small business and industry, and tobacco marketing. In addition, the government has mandated a program of concessionary credit to the private sector through the state-owned commercial banks. In 1993, concessionary credit was provided for export finance, locally manufactured machinery, and

agricultural production loans to small farmers. The export finance scheme is available to all commercial banks, but it is mandated explicitly only for the state-owned banks. In practice, private banks make little use of this program, and lending under the export finance scheme is dominated by the state-owned and newly privatized banks.

Banks also are required to place 10 percent of demand and time liabilities into accounts with the State Bank. An additional 25 percent must be held in government securities.

In November 1993, the governor of the State Bank of Pakistan reported that the total volume of overdue loans in the commercial banking sector was estimated to be 47 billion rupees. According to prudential regulations, a loan is considered to be "overdue" when a borrower fails to make any payment for a period of 90 days. After 180 days the loan is considered "substandard," and after one year it becomes "doubtful." Nonbank financial institutions had an additional 17 billion rupees of overdue loans. The defaulted loans are held almost exclusively by the three largest state-owned banks, and by the two newly privatized Pakistani banks. According to the State Bank governor, past due loans make up from 10 to 30 percent of these banks' loan portfolios. In contrast, foreign banks, including U.S. banks, have had few defaults and have enjoyed profitable operations.

The State Bank announced on January 1, 1993, that all banks would henceforth be required to establish reserves for loan losses and that banks would have until June 30, 1995, to comply with this new regulation. The reserves would have to amount to 8 percent of deposits and could be held in government securities. The earnings that are foregone in maintaining this reserve would be deductible as a business expense on federal taxes.

The relatively low profitability of the state-owned banks and the newly privatized banks is attributable to several factors, including:

- the requirement that state-owned banks maintain a large number of branches, often in remote and unprofitable locations;

- the requirement that state-owned banks provide credit to government concessionary schemes. The newly privatized banks, while not required to participate in such schemes, come under heavy pressure to do so;

- the employment, often under political or union pressure, of unnecessarily large staffs by the state-owned and newly privatized banks;

- less efficient operational and management practices employed by these banks; and

- the high volume of defaulted loans, many of which were accorded under political pressure.

Deposit Insurance

There is no system of deposit insurance in Pakistan, although the State Bank and the Pakistan Banking Council have considered instituting such a system. Foreign banks have reacted cautiously to deposit insurance because they fear having to subsidize the state-owned and newly privatized banks that are holding far weaker portfolios.

Elimination of Interest Payments

In 1979, Pakistan began a program of bringing its financial sector into conformity with Islamic economic principles by taking steps to eliminate interest. The two cornerstones of this policy are the use of the "markup" system in bank lending, and profit and loss sharing (PLS) for bank depositors. These two systems are now used for all rupee accounts in commercial banks (including rupee accounts of foreign banks). However, interest is still paid on foreign currency accounts.

Under the markup system, the lending institution purchases a share of the borrower's assets with an agreement to sell back the assets when the loan falls due at a fixed price, including the "markup." If the borrower is unable to pay when the loan falls due, the loan can be "rolled over" by extending a new loan for the amount of the original loan plus the previously agreed-upon markup amount. One shortcoming of this system is that nonperforming loans can be "rolled over" indefinitely so that a bank's balance sheet may not accurately reflect the viability of its outstanding loans.

Under the PLS system, banks declare a return on deposits periodically based on the profits actually earned on PLS deposits. In practice, banks announce expected PLS rates in advance, which have usually been reasonably accurate, so depositors have a good estimate of their rate of return before making a deposit. The range of rates paid on PLS deposits is quite wide. Selected PLS rates from commercial banks, for June 1993, are shown in the next table. However, the relative riskiness of the underlying loan portfolio is not reflected.

Ranges of PLS Deposit Rates Offered by Commercial Banks	
Demand Deposits	7.9 - 23.2
Time Deposits	
One Month	5.8 - 10.7
Two Months	9.0 - 10.7
Three Months	5.7 - 12.0
Six Months	6.4 - 13.5
One Year	6.7 - 13.6
Two Years	9.8 - 13.3
Three Years	11.1 - 14.4
Five Years	12.8 - 16.6

Source: State Bank of Pakistan

The Islamic Shariat Court in 1990 struck down 22 banking and financial laws because they condoned the payment of interest, which is expressly forbidden under Islamic law. The government subsequently asked the Pakistani Supreme Court to delay implementation of the ruling. The foreign banks, joined by a number of Pakistani banks, then appealed the Shariat Court's decision to the Pakistani Supreme Court where the case is still pending. With the appointment of a new Supreme Court chief justice scheduled for 1994, a hearing could be scheduled soon thereafter.

If the Supreme Court were to uphold the Shariat Court ruling and insist on the elimination of all forms of interest, this could have a significant impact on the banking system. One element of the current system expressly prohibited by the Shariat Court was the rollover of loans under the markup system. The Shariat Court ruled that instead of a rollover a defaulting borrower and the lender should submit the case to a banking tribunal for a ruling. Because "interest" would effectively stop accruing from the date that the loan was due, the borrower would in effect have an "interest-free" loan for the duration of the banking tribunal's hearing, providing all borrowers an incentive to default and to prolong the hearings.

A Supreme Court ruling that alters the current markup system and that makes foreign currency accounts also subject to a markup system would be certain to make U.S. banks reassess their operations in Pakistan. According to U.S. bankers, any system that requires the lending party to take an equity stake from the borrower would cause problems for most foreign banks. However, most observers do not expect that the Supreme Court will hand down such an extreme ruling, but that a workable compromise will be reached allowing foreign banks to continue

operating much as they do now.

The State Bank of Pakistan currently determines the maximum allowable markup rate, as well as the statutory liquidity ratio for commercial banks. At the end of 1993, the maximum markup rate stood at 22 percent and the statutory liquidity ratio was 35 percent. The governor of the State Bank has announced his intention to lower the maximum markup rate significantly, in progressive stages.

Commercial banks face considerable competition in attracting deposits from individuals and small investors the government's national saving scheme offers attractive rates of return on small accounts in the 12 to 14 percent range, which banks find difficult to match. The corporate bond market is still in its infancy in Pakistan. If this form of financial instrument becomes well-developed, then banks would face a more difficult time attracting deposits from businesses as well. With increasing competition from more efficient private banks, portfolios with a significant volume of bad loans, and the prospect of lowered markup ceilings, the state-owned banks will in particular face a difficult environment.

U.S. PRESENCE IN THE MARKET

The four U.S. banks operating in Pakistan — Citibank, American Express Bank, Bank of America, and Chase Manhattan — accounted for 6 percent of all commercial bank assets in 1992. All four banks are established as branches, as are all foreign banks in Pakistan. Citibank is the largest foreign bank operating in Pakistan. It is growing the size of its operation in Pakistan rapidly, as too are Bank of America and American Express Bank. Chase announced plans in 1993 to discontinue its retail operations in Pakistan, with the intention of concentrating on wholesale banking.

The U.S. banks have been selective in their choice of customers, and as a result have what most observers would agree is a quality client base. Like all other commercial banks in Pakistan, their principal activity is business lending. The U.S. banks tend to have a relatively high percentage of multinational corporations as clients.

Citibank has pioneered the development of consumer banking in Pakistan. In 1993, it became the first commercial bank to offer a comprehensive program for automobile loans and individual mortgages. Citibank also is planning to introduce a limited number of automated teller machines in 1994.

Assets, Deposits, and Profit before Tax of American Banks in Pakistan
(millions of rupees)

	Assets	Deposits	Profit before Tax
Citibank:			
1992	21,298	18,165	949
1991	12,191	10,854	386
1990	5,451	4,722	191
1989	3,494	2,646	152
American Express Bank:			
1992	9,799	7,436	652
1991	7,570	6,153	439
1990	4,647	3,527	297
1989	4,658	3,706	212
Bank of America:			
1992	8,265	6,233	599
1991	5,786	4,444	387
1990	3,769	2,754	239
1989	2,803	1,985	123
Chase Manhattan:			
1992	1,616	1,262	85
1991	1,581	1,287	81
1990	1,339	1,065	57
1989	1,355	1,039	30

Source: The Business Recorder, Karachi

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Other than normal prudential review by Pakistani banking authorities, Pakistan provides liberal entry requirements for foreign banks. Foreign banks are accorded the same treatment as Pakistani banks, with the following exceptions:

- Foreign banks may open a maximum of only four branches nationwide, whereas Pakistani banks face no such limitation;

- Disincentives to establishing in subsidiary form, and;
- Foreign banks are subject to higher withholding rates on taxes.

The limitation that foreign banks may open only four branches means that banks can be excluded from potentially profitable markets. Citibank, American Express, and Bank of America have all said that they would consider opening additional branches if they were allowed to do so. This limitation also effectively limits the number of automated teller machines (ATMs) that foreign banks can open because all banks are limited to opening just two ATMs per branch. Citibank plans to open its first ATMs in 1994, and has said that it would be prepared to open far more than the eight ATMs to which foreign banks are effectively limited. With its initiative aimed at developing a consumer banking market in Pakistan, the limitation of four branches is particularly restrictive for Citibank.

However, in mid-1994, Citibank received authorization from the State Bank of Pakistan to open up to 20 additional bank branches in the country. This represents the first time that any foreign bank has been permitted to have more than four branches.

The absence of foreign bank subsidiaries may be the result of rules governing their establishment. These require that equity shares be offered to the public at prices below the true market value and that at least 50 percent of the shares be held by the public.

The practice of applying a higher withholding tax rate to foreign banks is similar to the tax treatment of foreign companies doing business in Pakistan, or to foreign individuals residing in Pakistan. The higher withholding rate has no impact on final tax liability, but it does tie up funds that otherwise could earn a return. The withholding rate for foreign banks is almost twice that of domestic banks. Citibank has estimated that the higher withholding cost it approximately 1.5 million rupees in foregone interest earnings in 1993.

Many foreign banks contend that although their tax and regulatory requirements are the same as those applied to domestic banks, the rules are applied to foreign banks with considerably more administrative vigor. Several foreign banks say that State Bank prudential regulations are applied far more carefully to foreign banks, and that the State Bank is much quicker to impose penalties on foreign banks than on Pakistani banks, even for relatively minor infractions. Similarly, foreign banks argue that they face higher effective tax rates than Pakistani banks because tax regulations are imposed more rigorously on foreign banks. Foreign banks frequently assert that Pakistani banks may successfully avoid State Bank penalties or higher taxes due to favoritism by the regulatory agencies.

On the other hand, foreign banks readily admit that, unlike the state-owned or newly privatize banks, they face virtually no pressure from the government to accord concessionary financing to targeted development sectors. Foreign banks also are free from the political pressure exerted on state-owned and newly privatized banks to accord loans to politically popular projects or

borrowers. Many observers believe that these pressures are a major factor leading to the high percentage of defaulted loans that are burdening the state-owned and newly privatized banks. In this respect, foreign banks enjoy advantageous treatment.

ISLAMIC REPUBLIC OF PAKISTAN

SECURITIES

SUMMARY

Pakistan has a fairly large market for government securities, which are auctioned at U.S. Treasury-style auctions. The government securities market is regulated by the State Bank of Pakistan, which in 1991 abolished administrative controls and instituted a system of open market operations. Foreign investment in government securities is at a significant level.

The corporate bond market is nonexistent at the present time, but local analysts believe that this will be the next step in the development of Pakistan's capital markets. There are no options or futures markets at present. The government is trying to encourage brokers to offer more sophisticated services such as underwriting.

The equity market in Pakistan is dominated by the Karachi Stock Exchange. More than 650 companies were listed on the exchange at the end of 1993, with a total market capitalization of about $12 billion. Most brokers are individuals and the services offered are rather rudimentary. Pakistani pension funds are prohibited from investing in the stock market.

The only means by which foreign firms may establish in Pakistan is through a joint venture with a domestic broker. There is only one such joint venture partnership with an American firm in operation. Several American companies have established less formal relationships with Pakistani brokerage firms. Joint ventures are treated the same as comparable domestic institutions (they can undertake all activities that are permitted to local companies, including brokering and underwriting). However, joint ventures cannot establish mutual funds.

Pakistani policy is to encourage foreign investor participation in local financial markets. Changes in Pakistan's foreign exchange regulations in 1991 opened the securities market to foreign investors without limit. For the first time ever a non-state owned Pakistani corporation borrowed on the Euro-market in 1994.

DESCRIPTION OF THE MARKET

Regulation

The Corporate Law Authority (CLA) is the arm of the Government of Pakistan (GOP) that oversees the equity and corporate bond markets. Several pieces of legislation pertain to operational aspects of governing the equity market: the Securities and Exchange Ordinance of 1969 and the Securities and Exchange Rules of 1981. The Companies Ordinance of 1984 also regulates the stock exchanges by setting out provisions by which listed companies must operate, and the Control of Capital Issues Act determines the number of shares to be offered to the public. As the market continues to develop, the Corporate Law Authority is looking at

restructuring its authority and establishing a securities and exchange control board to address both day-to-day problems and long-term policy issues. Pakistan's three stock exchanges are largely self-regulated. However, the Corporate Law Authority has the authority to approve all regulations of the stock exchanges, so the CLA does exercise considerable leverage over them.

The central bank, the State Bank of Pakistan (SBP) regulates the government securities market.

Corporate Bond Market

The corporate bond market is nonexistent in Pakistan because, until very recently, there was no demand for such a market. There is no tradition in Pakistan of going to the public to raise funds. In many cases, sponsors of projects found they could obtain cheaper funds from the development finance institutions (DFIs), and thus had no economic rationale for undertaking a public offering.

This attitude may be changing, however. Currently, in lending to the DFIs, the international financial institutions have imposed additional conditions and covenants because many of the previous loans to the DFIs were not repaid. Therefore, as traditional, low-cost sources of funds have dried up, Pakistani companies have been considering the merits of developing a corporate bond market. At the same time, the government of Pakistan is considering floating its first sovereign debt issue, which would establish a benchmark for Pakistani private debt.

Several government-owned entities have paved the way for the issuance of corporate bonds in Pakistan. Both WAPDA (the Water and Power Development Authority) and the Civil Aviation Authority (CAA) have been allowed to issue bonds with a fixed-rate "markup" (i.e., interest), paid semi-annually and with a maturity of two to four years. And for the first time in Pakistan's history, a non-state-owned Pakistani company is going to the Eurobond market to raise funds. The first Pakistani Eurobond convertible offering will be listed in Luxembourg later in 1994. Although this does not constitute a corporate issue in Pakistan because the offering will be listed abroad, many analysts feel that this is the first step in the development of a local corporate bond market.

Government Securities Market

In 1991, the SBP abolished administrative control over the government securities market and instituted a system of open market operations. The government debt market in Pakistan has grown considerably over the past few years. Currently, outstanding domestic debt is approximately 200 billion rupees (about $6.67 billion), or 12.6 percent of GDP (FY 1993-94 ending June 30, 1994). The GOP now offers two types of securities: Treasury bills (with a maturity of six months) and three Federal Investment Bonds (with maturities of three, five, and ten years). Both instruments are guaranteed by the GOP.

The Treasury bills are zero coupon instruments issued through an auction system. The first Treasury bill auction was held in March 1991, and U.S. Treasury-style auctions are held every two weeks with settlement taking place the same day. Total outstanding volume was just over $2 billion as of year-end 1993. The rates are not predetermined at auction time, but by prevailing demand and supply. Treasury bills have recorded annual yields of between 12 and 16 percent, with the return in the form of a capital gain rather than a coupon payment. All foreign institutional investors must pay a withholding tax of 52 percent; local institutional investors pay 30 percent, while individuals pay 10 percent. The T-bill market is quite liquid, and the average daily trading volume in the secondary market is $25 to $30 million.

All banks, foreign and domestic, are required to hold a minimum of 30 percent of their balance sheets in Treasury bills as part of the SBP-mandated 35 percent reserve requirement (the additional 5 percent must be held in cash). However, because lending to the Pakistani private sector is limited by the SBP to 32 percent of a bank's balance sheet, in practice most foreign banks tend to hold more Pakistani government paper than they are required to hold. One American bank estimated that it carries an average of 50 percent in Treasury bills, and said that this figure sometimes reaches as high as 60 percent. Banks choose to invest in Treasury bills because of the attractive return they offer and because they are very liquid.

Federal Investment Bonds carry coupons, with the issue price governed at auction when bids are invited. The first FIB auction was held in April 1991. The bids do not have to be at par value, but can reflect any yield the bidder desires. The total volume outstanding at the end of December 1993 was approximately $4.5 billion. The three-year bonds pay 13 percent, five-year bonds 14 percent, and ten-year bonds 15 percent. Interest is payable semi-annually. As with Treasury bills, foreign institutional investors pay 52 percent withholding tax, while local institutional investors pay 30 percent and individuals 10 percent. Approximately $60-70 million is traded on an average daily basis in the secondary market.

Equity Market

The past few years have witnessed a quantitative and structural change in the securities market in Pakistan. The Karachi Stock Exchange (KSE), which was established in 1949 as a post-partition offshoot of the Bombay Stock Exchange, remained a rudimentary market up through the end of the 1980s, lacking the depth and sophistication of a true stock exchange. Beginning in the late 1980s, however, the government's efforts to promote equity investment began to manifest themselves in the KSE's performance, as the following table of indicators illustrates.

	Karachi Stock Exchange				
	1993	1992	1991	1990	1989
Total Companies Listed	653	628	542	487	438
New Listings During Year	38	86	61	49	38
Total Listed Capital (millions of rupees)	69,476	58,198	37,024	28,056	22,522
Market Capitalization (millions of rupees)	327,776	199,871	189,518	61,750	52,786
Average Daily Volume (millions of shares)	5.5	3.3	2.7	1.1	0.9

Source: Karachi Stock Exchange annual report 1993.

Measures to bolster confidence in Pakistan's equity market first began in 1985 when the government's budget exempted stock dividends from income tax.[1] In 1991, foreign exchange regulations were liberalized, the stock market was opened to foreign investors, selected sectors of the economy were deregulated, and the process of privatizing major public sector companies began (after over 20 years of state control). Most recently, the government's economic liberalization program, featuring a combination of reductions in taxes and tariffs, more privatization of state-owned enterprises, and further improvements in the environment for domestic and foreign investors, has supported the stock market's stellar performance. The KSE rallied between June and December of 1993, more than doubling in value. Furthermore, unlike performances in many other emerging markets, the KSE did not experience a substantial correction just prior to the year-end close-out of company books. The new issues market remained fairly buoyant: an amount of Rs 3.6 billion was raised through 57 new issues in 1993, compared with Rs 5.2 billion through 37 new issues in 1992.

A good performance in the Pakistani equity market is expected in 1994, given the outlook for sustained improvement in corporate earnings growth, high liquidity from the local retail base, increased foreign institutional purchases, and new issues.

[1]This tax exemption has since been removed.

Both the government of Pakistan and the business/financial community realize the importance of developing institutions to withstand the challenges of the current environment. For example, the Corporate Law Authority is now encouraging KSE members to offer more sophisticated services, such as underwriting, instead of the rudimentary brokerage services traditionally offered in Pakistan. The CLA also is urging members of the KSE to incorporate themselves.

Two other stock exchanges, one each in Lahore and Islamabad, also are in operation. The Lahore Exchange, which was established in 1970, functions principally as a regional market. More than 75 percent of the companies listed on the Lahore Exchange are also listed on the Karachi Exchange. As of December 31, 1993, 560 firms were listed on the Lahore Exchange, with a market capitalization of 317.4 billion rupees. The Islamabad Exchange was established in 1992; all of the firms listed on it are also listed on the Karachi Exchange. By the end of 1993, 194 firms, with a market capitalization of 245.3 billion rupees, were listed on the Islamabad exchange.

Membership in all three stock exchanges is limited, and seats must be purchased. Exchange members must be Pakistani nationals. Brokers are required to be members of one of the three exchanges. Currently, there are 11 incorporated brokerage houses operating in Pakistan, which are described by the Chairman of the Corporate Law Authority as being of "fairly reasonable quality."

In order to enhance its effectiveness, the KSE is also working to set up a central depository company to replace the existing manual method of handling the transfer of shares. The company, which is a joint venture of the Karachi, Lahore, and Islamabad exchanges, the IFC, Citibank, Muslim Commercial Bank, the National Investment Trust, and the Investment Corporation of Pakistan, should be operational by the end of 1994. The KSE is also in the process of setting up a computerized system to match bids and offers automatically.

Options/Futures Market

Financial options and futures markets do not yet operate in Pakistan because each requires a more sophisticated operating environment than Pakistan's financial market currently offers. With the establishment of the Central Depository Company and continued deepening of the market in Pakistan, however, the establishment of such markets may be an option for the future. Presently, a futures market does operate in Pakistan for purchases and sales of currency futures in connection with trade-related transactions.

Fund Management

Mutual funds are emerging as important financial instruments in Pakistan. Private sector entities may establish closed-end funds, and draft permitting the launch of open-end funds have been prepared and presently await government approval.

In the public sector, the Investment Corporation of Pakistan (ICP) is a government development finance institution established in 1966 to develop the capital market and broaden the base of equity investment. ICP sponsors closed-end mutual funds and has about 22 funds listed on the KSE.

The National Investment Trust (NIT) is also a public sector development finance institution, established in 1962 to mobilize savings for investment in the securities market as well as manage mutual funds. NIT usually invests only in leading companies, and has established one open-end fund.

Pakistani pension funds are prohibited by law from investing in equities because the market has been considered too risky an investment. However, the government of Pakistan is currently studying whether to change existing regulations to allow pension funds to invest in the stock market.

In the near future, the CLA is expected to announce new regulations concerning foreign firms' activities in Pakistan with regard to asset management, open-end mutual funds, and foreign-currency denominated mutual funds.

Capital Movements

New foreign exchange regulations issued in May 1991 opened the securities market to foreign investors, but with no limit on foreign participation except for government securities (in which individual foreign companies are restricted to investing only up to 30 percent of their funds). Although precise figures are not available, the Karachi Stock Exchange estimates that approximately $1 billion of the $12 billion invested in the equity market is foreign money. No figures are available on the percentage of U.S. participation in the market.

U.S. PRESENCE IN THE MARKET

U.S. presence in Pakistan's securities market is quite limited. At the present time, there is only one joint venture partnership between a U.S. firm (Bear Stearns) and a Pakistani brokerage firm. Several other American firms have established less formal relationships with Pakistani brokerage firms.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Brokers in Pakistan are required to be members of one of the three Pakistani stock exchanges. Exchange members must be Pakistani nationals. Although only stock exchange members may establish brokerage houses, Pakistani brokers are free to enter into joint venture relationships with foreign firms. (Foreign securities firms may not enter as a branch or a wholly-owned subsidiary.)

Although foreign entry into Pakistan's securities markets is limited to a minority ownership in a joint venture, such partnerships are treated as Pakistani entities and are accorded the same privileges as wholly-owned Pakistani firms, including the right to obtain a seat on an exchange, as well as to broker and underwrite new issues in Pakistan.

Among foreign financial institutions, only investment banks can establish mutual funds, and brokers, regardless of whether their firms are Pakistani or joint ventures, are precluded from establishing mutual funds. Only closed-end funds are currently allowed, although the government is looking at the possibility of authorizing open-end funds.

PHILIPPINES

BANKING

SUMMARY

Thirty-three commercial banks dominate the Philippine financial system and the top five banks control about half of the commercial banking system's assets. Fifteen of the largest commercial banks are "universal banks," which can perform investment house activities (such as securities underwriting) and invest in the equity of non-allied undertakings, as well as their regular commercial banking functions. The Central Bank, known as the Bangko Sentral ng Pilipinas (BSP) since its 1993 financial restructuring, is responsible for regulating all types of banks in the Philippines.

Four of the commercial banks are wholly-owned branches of foreign banks, two of which are American. These banks were grandfathered by the 1948 Banking Act, which prohibited the entry of majority foreign-owned banks into the domestic market. Foreign banks control 8.8 percent of the banking system's assets and U.S. banks alone account for 6.4 percent. As of year-end 1993, U.S. banks in the Philippines operated four branches with assets of $2 billion and U.S. banks owned shares of local banks with assets of $5 billion. Six of the 17 offshore banking units (OBUs), and four of the 14 representative offices, are American. Four U.S. banks had minority interests in four commercial banks. U.S. banks account for about a third of the 31 representative offices and offshore banking units now active in Manila.

The 1948 prohibition on entry of new foreign banks remained in effect until May 18, 1994, when President Ramos signed into law a measure that provides for a five-year window during which up to 10 foreign banks can enter by establishing full service branches. While the legislation was less liberal than other versions that had been considered, it represents a step forward and provides an opportunity that foreign banks intend to utilize. The new law also raises, without time or numerical limit, the allowable foreign percentage ownership in new locally incorporated subsidiaries of foreign banks in the Philippines, from 40 percent to 60 percent. Similarly, the permissible foreign ownership in an existing Philippine bank was also increased from 40 percent to 60 percent. The prohibition on expansion of the branch network by the four existing foreign banks was also partially removed. Another important aspect of the new law is that it will enable foreign commercial banks willing to meet capital requirements to become universal banks and engage in securities underwriting for the local market. A potentially important limitation in the legislation is that it provides that majority Filipino-owned banks must control 70 percent of total banking system assets.

At the end of 1993, five Philippine banks operated one agency, one representative office and seven branches in the United States. This presence represents an increase of two branches since the end of 1989.

DESCRIPTION OF THE MARKET

The Philippines' first bank, the Bank of the Philippine Islands, was established in 1851. Several current commercial banks are direct descendants of Spanish and American banks set up during the two colonial eras. The Philippine government has controlling interest in two domestic banks, one of which, The Philippine National Bank (PNB), is also the country's largest commercial bank.

In 1948, two years after achieving independence, the Philippines prohibited the entry of majority foreign-owned banks into its domestic market. Commercial banking expanded rapidly from 1950 to 1972 with the creation of 27 new commercial banks, most of which were dominated by wealthy families. The 1970s, however, were also marked by a shift towards more interventionist policies, with the government setting relatively low ceilings on both deposit and loan rates and dictating preferential interest rates for favored industries and projects. The banking system was used as a channel for political favoritism and did not efficiently allocate capital. These imprudent lending policies helped precipitate the collapse of several banks in the early 1980s.

To restore stability and public confidence, the government lifted caps on deposit and lending rates in 1981 and subsequently increased capitalization requirements. Also, beginning in 1977, Philippine authorities sought to limit competition by refusing to issue new commercial banking licenses. The licensing moratorium lasted until 1989. Three new banks have since entered the market. Branch banking rules for domestic banks have also been liberalized. Under the recent reforms introduced in 1993, domestic banks are now generally free to establish branches when and where they decide, upon compliance with certain conditions and capital requirements.

Structure of the Banking Market

The banking sector is comprised of commercial banks, thrift banks, rural banks, and two government banks that specialize in developmental and agricultural lending. These banks hold nearly 80 percent of the Philippine financial system's total assets. Commercial banks dominate the banking sector with over four-fifths of its assets, deposit liabilities, and total loan portfolio. The Philippine commercial banking market is highly concentrated, as the five largest banks constitute roughly half of total commercial bank assets.

Philippine Financial System[1]
December 31, 1993
(billions of pesos)

	Assets	Liabilities	Net Worth
Total Financial System	1,329.7	1,008.9	320.8
Banks	1,016.8	897.5	119.3
Commercial Banks [2]	862.1	767.3	94.8
Thrift Banks	74.6	65.4	9.2
Rural Banks	22.7	18.3	4.4
Specialized Govt. Banks [3]	57.4	46.5	10.9
Nonbank Financial Intermediaries	304.0	110.5	193.5
Nonbank Thrift Institutions	8.9	0.9	8.0

[1] Excludes Philippine Central Bank; includes Insurance Companies.
[2] Includes data for 13 universal banks. In 1994, two more commercial banks upgraded to unibank status, bringing the current number of universal banks to 15.
[3] Development Bank of the Philippines and Philippine Amanah Bank (an Islamic bank).

Source: Bangko Sentral ng Pilipinas

There are currently 39 commercial banks operating in the Philippines, including four wholly-owned branches of foreign banks. Privatization has reduced National Government control of PNB from 100 percent to 57 percent, with further privatization planned. Ownership and control of each of the individual private domestic banks are largely in the hands of one or two prominent families. While an individual or family unit cannot own more than 20 percent of a given bank, this is often sufficient to control the bank. These same families also tend to have major interests in nonfinancial sectors. The new bank law will allow reputable Filipino corporate units, or corporations whose stock is listed on the stock exchange, to own up to 60 percent of a single bank.

Lending rates, while on a downtrend due in part to a strengthening peso and the government's improved fiscal position, remain high. High reserve requirements (recently reduced to 19 percent), the gross receipts tax, and other regulations (such as mandatory lending to the agricultural sector and to small enterprises or, alternatively, investments in eligible low yielding government securities) contribute to substantial intermediation costs. Because of current government revenue difficulties, the gross receipts tax imposed on interest from lending activities remains despite widespread consensus that it distorts interest rates. Loans are largely short-term, reflecting concern with interest rate volatility as well as limited competition from alternative sources of longer-term capital such as the corporate bond market. Banking sector estimates

show that the nominal cost of funds, including intermediation costs, averaged about 14.7 percent from 1990 to 1993. Nevertheless, commercial banks, including the relatively smaller and less efficient institutions, have generally managed to operate profitably because of limited new competition and interbank cooperation. The commercial banking sector posted an average return on equity (ROE) of 18 percent in the last five years.

Philippine commercial banks can also engage in trust and investment banking services with prior Central Bank authorization. Fifteen of the largest commercial banks are "universal banks," which can perform investment house activities (such as securities underwriting) and invest in the equity of non-allied undertakings, as well as their regular commercial banking functions. The universal banks can engage in these activities directly, or if they choose, through subsidiaries. The new bank law will allow foreign banks to become universal banks and underwrite local securities.

Use of consumer credit cards and automated teller machines (ATMs) is also growing rapidly. The government relaxed regulations governing the establishment of ATMs in 1990. Foreign banks have been allowed to join shared ATM networks. In mid-1991, the Central Bank lifted the requirement that offsite teller machines may be opened only in service areas where a bank had an existing branch. Prior Central Bank approval for the establishment of ATMs is also no longer required.

Trust accounts, which are exempt from the gross receipts tax and, until recently, reserve requirements, have grown substantially in recent years. Current levels equal about a third of the commercial banking system's total liabilities and a fourth of its total assets. In October 1993, the government imposed a 10 percent reserve requirement on common trust accounts to mop up excess liquidity.

The government adopted regulations allowing offshore banking units (OBUs) in 1976 and the number of OBUs increased rapidly to 26 in 1983, when a recession and a balance of payments crisis halted growth. Regulations have also been gradually tightened, including prohibition on renewing medium-term loans as they fall due and restraint of permitted letter of credit guarantees, forcing a number of OBUs to cut back operations. OBUs are limited to foreign currency transactions. They are not allowed to establish branches or engage in peso transactions of any kind including taking deposits. OBUs in the Philippines concentrate on trade finance, correspondent banking and foreign currency lending/deposit taking. Many also engage in financial advisory services and risk management. A few are active in foreign exchange and debt/bond trading. As of December 1993, the OBU system's total assets stood at $1.6 billion. Although the system's resources come from outside the Philippines, most of its funds have been lent onshore (either directly to nonbank customers, or to domestic commercial banks for relending to nonbank customers), helping to supplement the limited supply of domestic capital.

Bank Regulation

The Central Bank, known as the Bangko Sentral ng Pilipinas (BSP) since its 1993 financial restructuring, is responsible for regulating all types of banks in the Philippines. The Philippine Deposit Insurance Corporation (PDIC), patterned after the U.S. Federal Deposit Insurance Corporation (FDIC), has played a relatively minor role by only occasionally assisting in packaging rehabilitation schemes for troubled banks. Limited capitalization has also prevented it from settling claims of depositors promptly. In order to expand the PDIC's role, a law passed in 1992 now designates the PDIC as receiver of troubled banks. That same law also increased PDIC's insurance fund and more than doubled, to 100,000 pesos, the amount of insured deposits per depositor. The Bankers' Association of the Philippines (BAP), which conducted on-floor foreign exchange auctions until the liberalization of the foreign exchange market and the establishment of an electronic off-floor electronic dealing system in 1992, is the domestic lobbying group and includes the four resident foreign banks. There is also an association of offshore banking units.

U.S. PRESENCE IN THE MARKET

Four of the 33 commercial banks operating in the Philippines are wholly foreign-owned bank branches which were grandfathered by the 1948 Banking Act. Two of these are branches of U.S. banks: Citibank and Bank of America. Citibank began operations in 1902 and is the largest foreign bank branch in the Philippines. It is also among the 10 largest commercial banks in the country. Bank of America established its branch in 1947. The other two foreign banks are British-owned: Hong Kong and Shanghai Banking Corp. and Standard Chartered Bank.

Besides these branches of foreign banks, foreign banks/institutions also have foreign equity participation in domestic commercial banks, limited by the 1948 banking law to no more than 40 percent. The new bank law will allow a foreign bank to own up to 60 percent should it choose this as its single mode of entry. A number of U.S. banks own a minority interest in domestic commercial banks. In recent years, some U.S. banks have sold their equity shares in domestic banks.

Philippine domestic banks dominate the commercial banking system. In recent years, the share of assets held by foreign and U.S. banks has fallen, partly because more commercial banks have opened as restrictions on starting new banks have been lifted. Write-offs during the debt crisis in the 1980s and the more recent commercial debt buy backs also reduced the share of assets held by foreign banks.

In 1993, wholly-owned foreign bank branches controlled 8.8 percent of the banking system's total assets. U.S. banks accounted for 6.4 percent of total assets. In 1989, foreign banks controlled 10.6 percent and U.S. banks, 8.0 percent of total assets. As of December 1993, Citibank and Bank of America, operated four branches with assets of 55.3 billion pesos ($2.0 billion). U.S. banks owned shares of local banks with assets totalling about 153 billion pesos ($5.0 billion) as of December 1993.

There are currently 14 representative offices of foreign banks in the Philippines. Of these, four are American. There are also currently 17 offshore banking units in the country, of which six are American.

Foreign and U.S. Presence in Commercial Banking Sector
December 31, 1993
(billions of pesos)

	Assets	Liabilities	Net Worth
Total Commercial Banks	862.1	767.3	94.8
Wholly Filipino-Owned	543.2	477.2	66.0
Wholly Foreign-Owned	76.0	74.2	1.8
Wholly U.S.-Owned	55.3	54.2	1.1
Citibank	47.3	46.4	0.9
Bank of America	8.0	7.8	0.2
Wholly British-Owned	20.7	20.0	0.7
Hongkong & Shanghai	15.2	14.9	0.3
Standard Chartered	5.5	5.1	0.4
Joint Filipino-Foreign	242.9	215.9	27.0
of which Filipino-U.S.	139.2	122.5	15.7

Sources: Bangko Sentral ng Pilipinas; published financial statements (for jointly owned Filipino-U.S. banks)

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

With the passage of the General Banking Act in 1948, the licensing of new foreign bank branches was prohibited in the Philippines. The four existing foreign bank branches, however, were allowed to retain 100 percent ownership. The same law also prohibited wholly foreign-owned banking subsidiaries even if incorporated domestically, limiting foreign ownership in Philippine banks to 30 percent of voting stock. Up to 40 percent foreign control of voting stock was possible with presidential authorization, which was generally attainable.

Applications to establish new domestic commercial banks were generally denied from 1977 to late 1989. During that time, foreign banks wishing to invest were limited to buying up to 40 percent of voting stock in existing domestic banks. Those offered for sale were usually in financial difficulty. A number of foreign banks, including U.S. banks, have undertaken such

purchases. Lifting the ban on new domestic commercial banks opened up opportunities for foreign investors, but only in joint ownership with Filipinos.

On May 18, 1994, President Ramos signed a law liberalizing foreign banks' access to the Philippine financial sector, the first major opening since 1948. This law represents substantial progress, although domestic proponents of vigorous economic opening and the international banking community had hoped the terms would be less restrictive. Implementing regulations were issued in October 1994.

The law will allow a foreign bank to enter the market in one of three ways: as a full service branch, or by owning up to 60 percent of either a locally incorporated subsidiary or an existing Philippine bank. In the next five years, six new foreign banks can enter on a branch basis, with four more allowed at presidential discretion. There is no time limit on other modes of entry. Banks entering on a full service branch basis can establish a maximum of six service branches. The existing foreign banks may add up to six new branches. Some have three at present.

Foreign banks must assign 210 million pesos ($7.7 million) in capital for the first three branches. Additional branches require 35 million pesos ($1.3 million) per branch and the monetary board determines their location. Foreign banks must also remit and convert at least 15 percent of their net due to home office accounts into pesos with adjustments allowed for significant involvement in certain activities, e.g., exports. According to the provisions of the new law, to set up a branch or local subsidiary, a bank must be either among the top five banks in its country of origin or among the top 150 banks in the world. The details on these criteria are in the law's implementing guidelines. The legislation also mandates that majority Filipino-owned banks control 70 percent of total banking system assets. The law allows foreign banks assigning 1.5 billion pesos ($55 million) in capital to become universal banks and engage in securities underwriting. The new law does not explicitly grandfather the rights of existing branches and minority equity stakes of foreign banks, but the implementing rules and regulations do so.

U.S. and other foreign bankers indicated that they are made aware of regulatory and legal changes and that their opinions were solicited. This was certainly the case during the recent bank liberalization bill process, when foreign bankers were allowed to testify before the Philippine congress.

PHILIPPINES

SECURITIES

SUMMARY

The Philippine securities market is small and relatively underdeveloped. Trading tends to be concentrated in government securities, with most, in fact 70 percent, of government paper carrying maturities of less than one year. Equities account for the largest share of nongovernment capital market instruments, but trading in equities also is highly concentrated. As of end-1993, four firms accounted for nearly one-half of the market's capitalization. The corporate bond market also is small. Most corporate clients in the Philippines borrow directly from banks or from trust funds. Although a futures market exists, trading is not substantial. Mutual funds are a recent innovation. Given the underdeveloped state of the Philippine financial market, there is not much demand for innovative new products, such as derivatives.

Foreign securities firms are allowed to establish wholly-owned, domestically incorporated broker-dealers. However, they may own only minority stakes in securities firms that provide services in addition to broker-dealer activities. Several foreign firms, including three U.S. firms, have seats on the Philippine stock exchange.

Branches of U.S. banks are active in trading foreign exchange and government securities. They also can write futures contracts. Two U.S. banks have stock brokerage firms. A recent liberalization of the banking laws, signed into law May 18, 1994, will afford U.S. and other foreign banks the possibility of operating as universal banks. This will enable them to, among other things, underwrite Philippine debt and equities for the local market.

DESCRIPTION OF THE MARKET

Government securities are the dominant instruments in the Philippine securities market. The markets for private debt and equity are not well developed.

Financial institutions in the Philippines include universal banks, which are able to broker, deal, and underwrite bonds and equities directly. They do not need to establish separate subsidiaries to broker equities or to underwrite securities. In practice, however, many universal banks establish separate investment houses to undertake securities-related operations/activities. A few have spun off separate entities to handle brokerage activities only.

Before the law liberalizing the entry of foreign banks was signed in May 1994, universal banking was confined to domestic banks. The new law will allow foreign banks to become universal banks and will allow them to engage in securities activities directly, upon compliance with capital and other requirements (specifics not yet available, pending finalization and official release of implementing rules and regulations, expected in either late October or early November).

Government Securities Market

The Philippine government continues to finance its budgetary deficits with short-term debt instruments, usually 90-day T-bills. The government also has had to issue securities beyond its own needs in order to assist the financially-strapped Central Bank. The financial restructuring of the Central Bank in the fall of 1993 should help to reduce this need in the future.

About 70 percent of government paper has a maturity of less than one year — although the government is seeking to lengthen maturities. It has had some success with the introduction in 1991 of three-year floating rate Treasury Notes, whose rates are at a 0.5 percent premium to the T-bill rate and adjust every six months. The government bond market is small, and there are virtually no new issues of longer-term public debt instruments. Most bonds outstanding carry below-market coupon rates and are reserve-eligible. Financial institutions use them for this purpose.

Commercial banks dominate both the primary and secondary markets for trading of public sector securities. Since 1986, the government has issued government securities by auction. Only accredited dealers in government securities can participate in the auction, and most of the 25 dealers are commercial banks. One of the primary dealers is U.S.-owned (Citibank). There is a proposal pending before the Philippine Monetary Board to open up the auctions to foreign banks and other securities dealers.

The secondary market, which is an over-the-counter market, is relatively inactive, partly because the market lacks market-makers. Market liquidity also means that purchasers tend to demand higher interest rates. A May 1994 case of fraud in the secondary market caused two banks to lose about $30 million when securities they purchased were never delivered.

The top six dealers of public sector securities, all commercial banks, account for over a third of secondary market transactions. As of December 1993, holders of outstanding government securities were as follows: private sector (32 percent), banking institutions (50 percent), Social Security System and Government Service Insurance System (8 percent), and trust funds (5 percent).

Financial institutions from the U.S. such as commercial banks, investment banks, and mutual funds are active investors in Philippine Treasury bills. Under the Philippine-U.S. Tax Treaty, the maximum tax rate on interest income imposed on American investors is 15 percent. However, U.S. investors report that, when investing in Philippine government securities for which the withholding tax rate is 20 percent, it is often difficult to get a rebate of the 5 percent excess tax withheld.

Philippine Securities Market
December 31, 1993[1]

	Billion Pesos	Percent Share[3]
Total	723.1 [3]	100.0
Government Securities	653.1 [2]	90.2
Total Short-Term	456.1	
of which T-Bills	413.3	
Capital Market Instruments	67.2	9.3
Shares of Stock	51.4 [2]	
Long-Term Commercial Papers	9.4	
Bonds	3.8	
Proprietary Shares	0.9	
Warrants	0.2	
Asset Participation Securities	0.9	
Asset Backed Securities	0.6	
Short-Term Commercial Papers	2.8 [2]	0.4

[1] Refers to cumulative sales through the years, unless otherwise indicated that the value given is an outstanding level.
[2] Outstanding level.
[3] Rough estimate only, being a combination of cumulative and outstanding values

Sources: Securities and Exchange Commission; Bangko Sentral ng Pilipinas; Philippine Treasury Bureau.

Equity Market

The Manila stock market was founded in 1927, making it one of the oldest in Asia. In 1963, some Manila exchange brokers left to set up the Makati Exchange (also in Manila). Although required by law to list the same issues, prices usually differed between the exchanges and arbitrage was possible. Trading was separate and brokers had seats on only one exchange. The merger of the two exchanges (now officially known as the Philippines Stock Exchange or PSE) was announced early in 1993. In early March 1994, the phasing in of computerization to link the two exchanges began and was completed in April. Steps are now underway to link up the PSE with brokers in Cebu. Other proposed improvements in the market are greater automation and introduction of a book entry system.

Despite a remarkable performance in 1993, when the index rose by 150 percent, the Philippine stock market remains small and narrow relative to those of neighboring countries. As of end-1993, four firms accounted for almost one-half of the market's capitalization and dominated the market index. Market capitalization at the end of 1993 stood at about $39 billion. However,

initial public offerings of closely held corporations and further privatization of attractive government firms should help to broaden the market.

Participants in the equity market include universal banks, broker-dealers, and investment houses. Universal banks can offer a full range of securities activities (see banking chapter for additional details). Broker-dealers face relatively low capital requirements (10 million pesos) and their activities are limited to brokerage and dealing activities. Investment houses are subject to higher capital requirements (100 million pesos) and can participate in a broader range of activities such as securities underwriting and the provision of consultant and advisory services. Subject to prior Bangko Sentral authorization, these entities are permitted also to act as investment/portfolio managers. The major underwriters in the domestic market are investment house affiliates of the universal banks.

Corporate Bond Market

A few prominent companies are the dominate issuers in the very small primary market for corporate bonds. A history of high and volatile interest rates has created a preference for short-term instruments rather than long-term bonds. Other factors that have impeded development of a private bond market are the competitive pressures from the large volume of short-term public sector securities, the virtual absence of a secondary market in long-term issues for liquidity and pricing purposes, and the lack of information available to investors on the creditworthiness of corporate bond issuers. Instead of corporate bonds, most corporations finance their operations by borrowing from commercial banks using trust accounts.

Mutual Funds and Pension Funds

Mutual funds are available in the Philippines, but they are a recent innovation and the total asset value of funds outstanding is relatively small. Broker-dealers are prohibited from managing mutual funds and local pension funds. However, investment houses can manage these funds subject to Bangko Sentral authorization, and by meeting an additional capital requirement of 150 million pesos, bringing the total capital requirement to manage mutual funds to 250 million peso. Banks seeking to manage local pension funds or other institutional monies must obtain a trust license from the Bangko Sentral ng Pilipinas.

Philippine residents may freely invest in offshore mutual funds, provided the foreign exchange used to make the investment, if purchased from the banking system, does not exceed $3 million per investor, per year. For most individuals, this ceiling on access to foreign exchange does not represent a practical problem.

Futures Market

Futures markets in the Philippines are mainly geared towards agricultural commodities with contracts available for up to 150 days. The sole market, the Manila International Futures Exchange, also offers spot trading of major currencies against the peso. There is one foreign currency futures contract, a 30-day dollar-peso, but little activity because the economy is essentially a two-currency one (dollar and peso). Few firms seek forward foreign exchange cover in the Philippines. Philippine T-bill futures are quoted for 60 and 120 days, but trading is quite limited.

Introduction of New Financial Products

There are no specific legal constraints to prohibit new products and innovation in the Philippines. However, the Philippine market is underdeveloped and no significant interest has been shown in the use of sophisticated instruments. Domestic and foreign firms are subject to the same rules.

Regulatory Agencies

Patterned after the American regulatory model, the Philippine Securities and Exchange Commission (SEC) was established in 1936. Beyond its securities market regulatory responsibilities, it registers companies and corporations, keeps and examines records of annual financial statements, and investigates and prosecutes breaches to the Corporation Code. It also oversees underwriters, brokers and dealers, financing companies, and mutual funds. The stock exchanges also seek to regulate themselves, but they have limited resources for this task. With the assistance of the United States Agency for International Development (USAID), the SEC, and the Philippine Stock Exchange are in the process of developing a computer-based market surveillance system designed to detect aberrations or irregularities in stock market trading activities. The Department of Finance (through its Treasury Bureau) and the Central Bank oversee the government securities market.

Access to International Capital Markets

Under current regulations, residents of the Philippines may freely invest offshore provided the foreign exchange they use to make foreign investments, if purchased from the banking system, does not exceed certain annual limits. If purchased from the banking system, the current limit is $3 million per investor, per year. Offshore investments above this ceiling require the approval of the Bangko Sentral ng Pilipinas.

Because of the Philippines' high external debt, the Bangko Sentral regulates foreign obligations to ensure that payments can be serviced in an orderly manner and with due regard for the economy's debt-servicing capacity. All government-guaranteed private sector debt, irrespective of maturity, creditor, or the source of foreign exchange for servicing, must be approved by the

Bangko Sentral. As a general rule, Bangko Sentral registration is also needed for obligations that are to be serviced using foreign exchange purchased from the banking system (registration may take place after the transaction). In 1993, the Philippines re-entered the voluntary international capital market with nearly $1 billion worth of Euro-bond issues. Foreign firms (including U.S. companies such as J.P. Morgan, Citibank, Chemical Bank, Morgan Stanley, and Chase Investment) participated in underwriting these issues. There are no restrictions on equity issues abroad except for limits on foreign ownership in certain industries prescribed by the Philippine Constitution and the 1991 Foreign Investment Act's foreign investment "negative list."

U.S. PRESENCE IN THE MARKET

Branches of U.S. banks are very active in trading foreign exchange and government securities. They and OBUs can provide foreign exchange futures contracts, but the market is not large (see banking chapter for description of OBUs). Citibank is a major player in the government securities market and is the only foreign bank branch in the Philippines that is an accredited government securities dealer. In addition, Citibank, J.P. Morgan, and Chemical Bank each have a minority interest in accredited domestic institutions.

Citibank (which operates three branches) and Bankers Trust (which has an OBU) both have brokerage firms that own seats on the Philippine stock exchange. Another American-controlled firm, Ackerman & Co., also has a seat on the stock exchange.

Three domestic banks with minority American equity are currently allowed to engage in securities underwriting activities, by virtue of their universal banking license.

In 1993, Merrill Lynch closed its office because the Securities and Exchange Commission deemed it to be doing business with its representative office. The trade association for Philippine investment houses is not aware of any American investment in its members.

The scope of services that U.S. financial institutions provide is relatively limited, but this appears to reflect the limited stage of development of the market rather than regulatory impediments.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Securities broker/dealers incorporated under foreign laws are not allowed to operate as branches in the Philippines. They may enter the Philippine securities markets either as a representative office or as a wholly-owned, locally incorporated broker-dealer. In the case of investment houses, which are allowed a broader range of securities activities (i.e., underwriting), foreign participation is limited to minority (i.e., less than 50 percent) ownership.

In the case of firms engaged in trust activities and mutual fund management, the limitation on foreign ownership is 40 percent.

Prior to the passage of the May 1994 banking law, the only means by which foreign firms were able to underwrite local equity and bond issues was through indirect, minority ownership of a Filipino investment house. The new banking law allows foreign banks to operate as universal banks, which means they may now participate as lead underwriters of new security issues.

Once entry is made, there are no further distinctions made between wholly or partially-owned foreign firms and domestic firms.

Several firms have seats on the Philippine stock exchange. Foreign banks and foreign securities firms may sell foreign mutual funds to local investors. Foreign banks may also manage local pension funds and other institutional monies — provided they obtain a trust license. Three foreign banks currently have trust licenses.

Foreign banks also may participate as primary dealers in the government securities market; currently one U.S. bank is a primary dealer.

Subject to certain restrictions in the Constitution, and the 1991 Foreign Investment Law, foreigners are allowed to own shares of Philippine stock. Prior to 1994, issuers seeking foreign investment participation were required to list their shares in two classes — one limited to Filipino ownership and another, trading at a premium, available to either foreigners or Filipinos. This distinction is no longer required under revised SEC regulations, in consonance with the Philippines' more liberal Foreign Investment Law.

Foreign financial firms can participate in the underwriting and distribution of Philippine issues in foreign markets (i.e., Eurobond issues in 1993 marked the return of Philippine paper to the international capital market). U.S. firms also are able to provide advisory services and brokerage services cross-border. Residents' access to foreign securities is limited by an underdeveloped capital market and by limitations on outward foreign exchange capital investments (currently pegged at $3 million per investor, per year, if the foreign exchange funding the investment is sourced from the banking system).

American and other foreign financial services providers feel that they are aware of changes in the law and regulations and that their opinion is solicited. This was certainly the case with the recent bank liberalization bill process, during which they testified before the Philippine Congress and made their views known to legislators and administration officials.

Exchange Rates

Average 1993:	$1 = 27.120 pesos
End of year 1993:	$1 = 27.699 pesos

SINGAPORE

BANKING

SUMMARY

Banking in Singapore is essentially split into two markets: an offshore market and a domestic market. The offshore Asian Dollar Market is by the far the larger of the two, with total assets as of March 1994, of $633 billion Singapore dollars (US$398 billion) versus S$196 billion (US$121 billion) in the domestic market (excluding the Post Office Savings Bank). Singapore actively encourages foreign participation in the offshore market, which is dominated by U.S. and other foreign banks. Of the 132 commercial banks in Singapore, 119 are foreign-owned. These foreign banks are generally branches of their overseas parent.

The domestic retail banking market is considered overbanked by the government of Singapore, which has imposed a long-standing freeze on the number of full banking licenses granted to both foreign and domestic institutions. Even within these constraints, foreign banks that already have full licenses do not enjoy the same market access as domestic banks. Foreign banks cannot open new branches, and they are severely limited compared to domestic banks in the operation of off-premise automatic teller machines (ATMs).

Since the 1990 National Treatment Study, there has been no change in the restrictions on branching, and little change to limits on ATMs for foreign full licensed banks. However, some progress has been made in other areas. In 1991, foreign full banks were allowed to offer computer and telephone banking to individuals and corporations and to install electronic terminals at corporate clients' premises. In addition, the permissible level of foreign ownership in domestic banks was increased from 20 percent to 40 percent. For offshore banks, the overall lending limit to residents was raised from US$50 million to US$100 million.

Foreign banks do enjoy some advantages in treatment compared to locally incorporated domestic banks. For example, domestic banks may be required to maintain branches that they would prefer to close and to service small relatively unprofitable deposits. In addition, capital requirements imposed on domestic banks are higher and more stringently defined than those imposed on foreign banks by their home regulatory authorities.

A new issue has come to the U.S. government's attention since 1990. Seven local retail banks, but only one foreign bank, have the right to offer special low-interest accounts through which Singapore citizens can purchase securities with their national pension savings. Foreign banks interested in offering such accounts report that the CPF Board has advised them that it is not seeking to extend the program to any more banks.

Foreign banks in Singapore account for almost half of all nonbank deposits from residents and more than half of all loans to nonbank residents. Foreign banks lend over 70 percent of total trade financing in Singapore and account for over 60 percent of all banking profits.

There are now 13 U.S. commercial banks (with eight sub-branches) in Singapore, four less than in 1989, and nine U.S.-controlled merchant banks, unchanged from 1989. The number of representative offices maintained by U.S. banks in Singapore has dropped from four to two. Two of the four U.S. banks with full banking licenses merged in 1992, and one withdrew from retail banking at the end of 1993.

Despite the thinning of their ranks, the presence in Singapore of U.S. banks in financial terms has continued to expand in recent years. Their total assets have risen at an annual average of 4.3 percent since 1988 to reach a total of S$40.7 billion (US$25.1 billion) at the end of 1992. When contingent liabilities and commitments are included, the annual rate of expansion over the period was 33 percent.

DESCRIPTION OF THE MARKET

Singapore embarked on a strategy to develop into an international financial center in the late 1960s. In the course of this strategy, the government has deliberately sought to attract financial intermediaries to conduct offshore operations in Singapore by fostering a favorable tax and operating environment and by adopting a liberal but selective admission policy.

The Singapore government requires banks to maintain separate operations or "units," with their own set of books and balance sheets, for transactions in the domestic and external currency markets. Most of the 207 commercial and merchant banks in Singapore operate external currency units, known as Asian Currency Units (ACUs). Under the Banking Act, ACUs may not incur assets or liabilities denominated in Singapore dollars. On the other hand, ACUs do not have to hold required reserves against their liabilities, or observe minimum liquidity ratios. The offshore units also enjoy a concessionary tax rate of 10 percent. ACUs operate primarily in the Asian Dollar Market, the Asian counterpart of the Eurodollar market. As in its European counterpart, transactions are largely interbank, though nonbank customers also participate. The Asian Dollar Market has been the key to Singapore's growth as a major financial center.

Banks operating in the domestic market, known as Domestic Banking Units (DBUs) may engage in transactions in both foreign and local currency, but they face more stringent regulation. DBUs must hold a minimum cash balance of 6 percent of their liabilities with the Monetary Authority of Singapore (MAS). In addition, they must hold 18 percent of their liabilities in liquid assets (10 percent must be in the form of Singapore government securities, while the other 8 percent may be held in cash, government securities and/or trade bills). DBUs are subject to the standard corporate income tax rate of 27 percent.

Comparison Between the Domestic Banking Market and the Asian Dollar Market
(S$million)

End of Period	1989	1990	1991	1992	1993	As of March 1994
Total Assets						
Domestic Banking Unit	144,972	152,754	155,242	172,495	192,103	195,561
Asian Currency Unit	656,435	707,592	618,006	578,912	623,865	632,899
Loans & Advances & Advances						
Domestic Banking Units	59,890	67,099	74,423	80,037	91,369	94,337
Asian Currency Units	168,493	227,498	231,633	218,586	221,134	227,682

Note: All figures reflect commercial banks and merchant banks. Domestic banking unit figures also reflect finance companies.

Source: Monetary Authority of Singapore, annual report 1993/1994.

As is usually the case in offshore banking, transactions in local currency (Singapore dollars) for use outside of Singapore are restricted. Singapore is particularly sensitive about its currency because of the its unusually high dependence on external trade. As a consequence, changes in the value of the Singapore dollar have an unusually large impact on inflation. Recently, in response to concerns that excessive restrictions may jeopardize Singapore's ability to integrate with other regional economies, the government has slightly liberalized the use of the Singapore dollar overseas. New rules enacted in 1992 allow banks, including offshore banks, to make Singapore dollar loans overseas through their DBUs without notifying the Monetary Authority of Singapore if they are for the following purposes:

- exports from, or imports into, Singapore;

- performance bonds on behalf of Singapore parties, including guarantees in the construction industry; or

- hedges by forward sales of Singapore dollar receipts from exports to Singapore.

Banks are required to notify the MAS of the use of Singapore dollar credit facilities exceeding S$5 million by nonresidents, or outside Singapore by residents for activities other than those approved. The MAS approves these trades on a case-by-case basis. Typically, approval is provided for transactions involving trade with Singapore or economic activity in the republic.

The Monetary Authority of Singapore

The Monetary Authority of Singapore (MAS) is the regulator of the financial sector and the de facto central bank. Currency is issued and controlled by a separate board, the Board of Commissioners of Currency of Singapore (BCCS). Both bodies are statutory boards — quasi-government agencies organized like corporations — operating under the Ministry of Finance. The MAS, established in 1971, is responsible for formulating and implementing Singapore's monetary policies and regulates the financial sector through the Monetary Authority of Singapore Act, the Banking Act, the Finance Companies Act, the Development Loans Act, the Local Treasury Bills Act, the Insurance Act, the Securities Industry Act, and the Futures Trading Act. Apart from having stringent requirements, the MAS has a selective policy on the admission of both local and foreign financial institutions.

Singapore has no insurance mechanism for bank deposits. Foreign financial institutions are required to tender "comfort letters" to MAS assuring that their Singapore operations maintain sound liquidity and financial position at all times and that the parent will, on demand, make up for any liquidity shortfall in the Singapore operations.

The Association of Banks in Singapore (ABS), the Offshore Banks Consultative Committee, and the Singapore Merchant Bankers Association do not perform any regulatory functions, but they do serve as vehicles through which MAS can consult with the banking industry. Foreign and local banks participate in the ABS and sit on the council, but the organization's chairman is always from a local bank.

Commercial Banks

Three types of licenses are available to commercial banks in Singapore. The type of license that a commercial bank holds determines the services it can offer and the extent of its operations. Thirty-five commercial banks in Singapore hold "full licenses" that permit them to offer a full range of local and foreign currency banking services. This number includes all 13 Singaporean banks. There is no monetary limit on the Singapore dollar lending activities of fully licensed banks, but they must get permission from the MAS before opening new branches, or relocating existing ones. The MAS also considers ATMs equivalent to branches and subjects these activities to the same controls.

"Restricted" licenses, introduced in 1971, are held by 14 commercial banks. All are foreign owned. They can operate in the offshore Asian Currency Market under the same terms as fully licensed banks, but the activities of their Domestic Banking Units are limited. Restricted banks face no restrictions on the amount of their Singapore dollar lending to residents, but they can only have one main branch, cannot offer general savings accounts, and cannot accept fixed interest-bearing deposits of less than S$250,000 (about US$156,000) from nonbank customers.

The remaining 89 commercial banks hold "offshore" licenses. Offshore licenses are now the only option available to new entrants to Singapore's commercial banking industry. These banks operate primarily in the Asian Dollar Market. They cannot accept any interest-bearing Singapore dollar deposits from resident nonbank customers (except approved financial institutions), nor can they open more than one branch.

The MAS considers the domestic market overbanked and has not granted a full or restricted banking license to any foreign or local bank since 1973 despite the consolidation that has taken place among foreign fully licensed banks. Several U.S. banks have expressed an interest in moving up to full license status if MAS eases its current embargo of full licenses. Most other U.S. banks are satisfied with offshore status.

Since the MAS began granting offshore licenses in 1973, it has permitted offshore banks to make limited Singapore dollar loans, in response to their argument that the inability to lend to loyal customers in the domestic market would cost them offshore business. The MAS raised this "resident funding limit" (the maximum amount in domestic loans such banks may have outstanding at any time) from S$30 million to S$50 million in 1988, to S$70 million in 1992, and most recently in June 1993 to S$100 million.

Singapore's Commercial Banks

In addition to foreign bank branches, Singapore's domestic commercial banking industry is made up of six major banks and their seven subsidiaries. All 13 have full licenses. Over the years the industry has consolidated around the "Big Four" banks: the Development Bank of Singapore (DBS), the Overseas Chinese Banking Corporation, the Overseas Union Bank, and the United Overseas Bank. Together, these four banks accounted for four-fifths of local banks' S$111.3 billion (US$68.7 billion) in total assets and S$945.5 million (US$583.4 million) in net profits in 1992. Two-thirds of the 257 bank branches in Singapore belong to the Big Four, which also own or control 6 of the 27 finance companies in Singapore. Two medium-sized banks, Keppel Bank and Tat Lee Bank, are independent. The Big Four also either own or have a controlling interest in seven other local banks. Foreign ownership of publicly listed banks is limited through the use of "local" and "foreign" shares on the stock exchange. Only Singapore residents may purchase "local" shares. "Foreign" shares are restricted to a maximum of 40 percent of total equity.

Local banks are closely linked to the government. For example, DBS and Keppel Bank are controlled by the government. Temasek Holdings, the government's investment arm, is the principal shareholder of DBS. Similarly, Temasek Holdings is one of the main shareholders of Keppel Corporation, which is the largest shareholder of Keppel Bank.

It is common for senior government officials to sit on the boards of both domestic and foreign banks and for officials of both foreign and domestic banks to be on the boards of government-linked companies and the government's statutory boards. Currently, the Ministry of Finance's

highest ranking civil servant is also the chairman of DBS Bank. The current highest ranking civil servant in the Ministry of Trade and Industry serves as one of DBS Bank's directors. Bank of America's general manager is on the board of Singapore Telecom. The MAS must approve the appointment of all directors of locally incorporated banks.

Fully Licensed Commerical Banks in Singapore
1992/1993

	Total Assets[1] S$ million	Net Profit (After Tax) S$ million	No. of Banks	No. of Branches	ATMs
Singaporean	111,377	945.5	13	257	673
All Foreign[2]	90,229	273.7	22	90	61
U.S.	25,825	28932.0	3	7	3
Japanese	21,506	119.1	2	3	0

[1] Assets do not include contingent liabilities and commitments.
[2] Excluding three banks for which data on assets and profits were not available.

Source: KPMG Peat Marwick 1993 Survey of Financial Institutions in Singapore.

Restricted License Commerical Banks in Singapore
1992/1993

	Total Assets[1] S$ million	Net Profit (After Tax) S$ million	Number
Singaporean[2]	n/a	n/a	n/a
All Foreign[3]	47,426	134.6	14
U.S.	2,387	6.7	1
Japanese	20,129	51.9	2

[1] Assets do not include contingent liabilities and commitments.
[2] All local banks are full-license banks.
[3] Excluding one bank for which data on assets and profit were not available.

Source: KPMG Peat Marwick 1993 Survey of Financial Institutions in Singapore.

Offshore License Commerical Banks in Singapore
1992/1993

	Total Assets[1] S$ million	Net Profit (After Tax) S$ million	Number
Singaporean[2]	n/a	n/a	n/a
All Foreign[3]	488,912	1,329.4	83
U.S.	144,704	81.9	9
Japanese	238,835	385.5	16

[1] Assets do not include contingent liabilities and commitments.

[2] All local banks are full-license banks.

[3] Excluding 11 banks for which data on assets and profit were not available.

Source: KPMG Peat Marwick 1993 Survey of Financial Institutions in Singapore.

Merchant Banks in Singapore
1992/1993

	Total Assets[1] S$ million	Net Profit (After Tax) S$ million	Number
Singaporean	1,606	12.0	2
All Foreign	39,710	238.8	73
U.S.[2]	9,392	19.8	9
Japanese	5,656	19.2	18

[1] Assets do not include contingent liabilities and commitments.

[2] Excluding joint ventures in which U.S. interests do not have a majority share. Assets of Bank of America are not included; data were not available as it started its operations during the first quarter of 1993.

Source: KPMG Peat Marwick 1993 Survey of Financial Institutions in Singapore.

As noted above, MAS limits foreign equity in local banks to 40 percent, with individual (or related group) foreign investments kept to 5 percent of total shares. This represents a liberalization since June 1990, when the foreign equity limit was 20 percent. Foreign equity in Singapore's six largest banks is currently at the 40 percent limit.

Post Office Savings Bank

The Post Office Savings Bank (POSB) is modeled after the Japanese system. The POSB currently has 140 branches and 615 ATMs. Total deposits in 4.4 million accounts amounted to S$20.3 billion (US$12.5 billion). The POSB redeposited 60 percent of its deposits into the banking system in 1993 with both domestic and foreign banks, and, underscoring its importance, these redeposits accounted for 14 percent of total deposits. A significant amount of POSB's redeposits are with foreign banks.

The POSB was separated from the Postal Services Department under the Post Office Savings Bank Act in 1972 to mobilize domestic savings for public sector development. Since interest earned in POSB accounts is exempt from income tax, the POSB pays a lower interest (1.75 percent as of May 1994) on savings accounts over S$100,000 (about US$62,000) than on smaller accounts. The POSB cannot offer corporate accounts, finance foreign trade, or conduct foreign exchange transactions. POSB must invest at least 50 percent of its holdings in government securities, and may offer loans only for housing. The POSB is regulated directly by the Ministry of Finance rather than by the MAS.

Merchant Banks

Seventy-seven merchant banks operate in Singapore, of which 74 are foreign-owned. Their principal activities are underwriting, securities management, and interbank lending. Foreign owned merchant banks are generally established in Singapore as locally incorporated subsidiaries. Merchant banks must be approved by the MAS. Although they do not obtain licenses under the Banking Act, merchant banks can establish ACUs, which must comply with the Banking Act requirements. To obtain permission from MAS to operate as a merchant bank in Singapore, a financial institution's head office must be established as a bank, merchant bank, securities firm, or investment house. MAS reviews applications on a case-by-case basis and is likely to approve only the larger, better established applicants.

Merchant banks can raise funds from shareholders, or borrow from other financial institutions. Sixty-five percent of their funds are raised in the interbank market. They do not need to maintain statutory reserve and liquid asset requirements.

Nonbank Financial Institutions

Singapore's nonbank financial institutions include finance companies, money brokers, and representative offices. There are 27 finance companies in the Republic, with 103 branches and total assets of S$15 billion (US$9.5 billion). All but five are locally owned. Finance companies, like commercial banks, provide loans to nonbank customers. They also provide leasing, accounts receivable financing, and factoring services. Governed by the Finance Companies Act, they can accept time and savings deposits, but they cannot offer checking accounts, deal in gold or foreign exchange, or grant unsecured loans above S$5,000 (about

US$3,200). Nor can finance companies issue Singapore dollar negotiable certificates of deposits or directly finance international trade. They can only deal in Singapore dollars, and they pay and charge higher interest rates than banks.

There are 10 money brokers in Singapore. All are foreign owned. They function as intermediaries between banks for the placement of currency deposits and foreign exchange transactions. They are not obliged to disclose particulars about their transactions until they are concluded, which serves to maintain the confidentiality of the parties involved. The Singapore Foreign Exchange Market committee provides a forum for market participants to discuss matters of common interest relating to the market.

U.S. PRESENCE IN THE MARKET

In financial terms, the presence of U.S. banks in Singapore has expanded rapidly in recent years. The Singapore assets of U.S. commercial banks have risen at an annual average of 4.3 percent since 1988 to reach a total of S$40.7 billion (US$25.1 billion) at the end of 1992. The annual growth rate is considered higher, at 33 percent, when contingent liabilities and commitments are included. This has occurred despite a drop in the number of U.S. banks in the Singapore market since the previous National Treatment Study.

There are now a total of 13 U.S. commercial banks operating in Singapore, four less than in 1989. Security Pacific ceased operations when it merged with Bank of America in 1992, and Chase Manhattan has opted to focus exclusively on "restricted" and "offshore" banking activities from 1994, although it retains its full license. The two other U.S. full license banks are Bank of America and Citibank, which have a combined total of five branches. Nine merchant banks are fully U.S. owned, unchanged from 1989. American Express Bank is the only U.S. financial institution with a "restricted" license. The number of U.S. banks with "offshore" licenses declined from 12 in 1989 to 9 in 1993.

Fifty-three foreign banks have representative offices in Singapore. Two U.S. banks have representative offices, down from four in 1989. They are not permitted to carry out financial transactions, but can act only as liaison offices for their parent banks.

Data indicate that U.S. banks outperformed local banks on an average basis. Earnings per U.S. banks were S$96.4 million (U.S. $59 million in 1992 compared to S$72.7 million (U.S. $45 million) per local bank. Return on total assets (excluding contingent liabilities an commitments) was 1.1 percent for U.S. banks compared to 0.8 percent for local banks. The three U.S. full license banks in 1992 earned S$289.2 million (US$178.5 million) on assets of S$25.8 billion (US$15.9 billion), the majority of which came from the highly competitive Asian Dollar Market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Singapore's laws do not distinguish between foreign and domestic companies in the banking industry. The only legal distinction that exists is between the offshore (ACUs) and domestic units, and in the type of license held. Laws and regulations governing the banking industry are publicly available, and MAS provides a guidebook on regulations to banks to assist them with regulatory questions.

U.S. banks are generally happy with their operations in Singapore. The vast majority want to operate only in the offshore category. Differences in national treatment are confined to domestic retail activities for full license banks. Only one U.S. bank is seeking to expand its retail activities. The MAS considers Singapore overbanked in the retail sector and maintains that its ban on full banking licenses is designed to prevent "excessive" competition.

Concerns regarding the domestic retail market include the following:

- The MAS has not approved a new full banking license to either foreigners or locals since 1973. Several U.S. banks have expressed an interest in a full license if the current freeze is lifted.

- MAS policy limits foreign equity in local banks to 40 percent (raised from 20 percent in 1992), with individual (or related group) foreign investments kept to 5 percent of total shares.

- Commercial banks must seek permission to open new branches. The MAS routinely grants permission to local banks, but has not allowed a foreign bank to open an additional branch in over 20 years.

- The MAS defines offsite ATMs as branches, so foreign banks generally cannot locate ATMs beyond the walls of their premises. Since the previous National Treatment Study, the MAS has allowed, as an exception, U.S. banks to open ATMs at Singapore's international airport, in the transit area beyond immigration. The MAS also permits banks to install electronic terminals in the offices of corporate customers, and to provide telephonic services enabling individual depositors to make account balance inquiries or order checkbooks.

- MAS will not permit U.S. and other foreign banks to set up a new ATM network to compete with the Singapore's only existing network, NETS, which is owned by the Big Four and two other local banks. MAS's rationale is that a new network would circumvent the existing ban on foreign banks opening new ATMs. In 1993, the MAS provided a written assurance to the U.S. Embassy in Singapore that it does not prohibit foreign banks from participation in the existing network. In practice, however, this has not been meaningful, as the operators of NETS have turned down requests by U.S. banks to participate.

• Seven local banks, plus Hong Kong Bank, are authorized by the government-run Central Provident Fund (a national pension) to operate "CPF investment accounts," through which Singapore citizens can purchase approved stocks on the Stock Exchange of Singapore with their pension savings. Banks may pay very low rates of interest in these accounts, making them an excellent source of cheap funds. However, recent changes have reduced the advantages occurring to banks authorized to operate investment accounts. The CPF Board has turned down requests by foreign banks to operate such accounts, saying they are not seeking new applicants to the program.

There are also some areas in which the MAS exercises its flexibility to the advantage of foreign banks. For example, foreign banks have the freedom to include interbank borrowings from their head offices, branches, and other banks as capital funds. This is not allowed for local banks. This gives foreign banks the flexibility to borrow from the interbank market to increase loan or investment portfolios, as the prudential limits on loans and investments are pegged to capital funds. Interest paid on borrowings from head offices reduces foreign banks' tax liability in Singapore.

Exchange Rate
Dollar figures are calculated at the 1993 average rate of S$1.62 = US$1.

SINGAPORE

SECURITIES

SUMMARY

Singapore has a well developed financial sector. In 1993, income from financial services accounted for 12 percent of Singapore's S$89 billion (US$56 billion) in GDP. The long-standing policy of the government has been to develop Singapore into a regional financial center through policies the government hopes will be attractive to foreign financial institutions.

Singapore has five equity markets that operate under the umbrella of the Stock Exchange of Singapore. The Singapore International Monetary Exchange (SIMEX), established in 1984, was Asia's first financial futures market. The Monetary Authority of Singapore (MAS) regulates the financial sector.

Foreign securities firms have the same right to establish and offer financial products as do domestic firms with respect to government securities, unit trusts, merchant banking and financial futures. However, SES regulations restrict foreign equity ownership of SES "full members" to 49 percent. Although "international members" can be 100 percent foreign-owned, international members may not vote in an election of members to the SES Committee (the SES Committee is the Board of Directors of the SES).

Two U.S. companies have an equity stake in two members of the Stock Exchange of Singapore (SES). An additional 11 U.S. securities firms are active in Singapore as nonmembers of the exchange. Foreign financial institutions, including one U.S. company, also are active in the fund management industry, offerring a total of 76 unit trusts and funds (similar to mutual funds). Foreign financial institutions, including U.S. financial institutions, dominate activity in the futures market, with about 80 percent of the 15.7 million contracts traded on SIMEX in 1993 involving offshore clients. Two of the seven primary dealers in Singapore government securities are foreign-owned, both from the United States. Of the 77 merchant banks in Singapore, 75 are foreign owned — 9 of which are based in the United States.
Residents of Singapore face no capital controls or restrictions in obtaining offshore financial instruments. However, local companies, except local financial institutions, must obtain prior approval from the MAS when issuing Singapore dollar-denominated securities or notes in overseas markets. Foreign companies can participate in underwriting foreign issues made by local companies.

DESCRIPTION OF THE MARKET

Singapore is a small but prosperous city-state with a population of 2.9 million citizens and a per capita GNP of over US$17,000. The financial services sector, including banks and other financial institutions, accounted for 12 percent of Singapore's S$89 billion (US$56 billion) in

GDP in 1993. It has been a longstanding policy of the Singapore government to develop Singapore into a regional financial center, primarily by attracting foreign financial institutions to set up operations in the city-state.

The development of a domestic securities market in Singapore was slow until 1985. In 1986, the government revised the Securities Industry Act (SIA), and enacted the Futures Trading Act (FTA). Both of these acts give broad powers to the Monetary Authority of Singapore (MAS) to regulate the securities industry. The MAS, in turn, delegates much of the day-to-day regulation of the markets to the relevant exchanges. The government securities market is administered directly by the MAS.

The Monetary Authority of Singapore is a statutory board — a quasi-government body organized like a corporation — under the Ministry of Finance. Established in 1970, the MAS regulates the entire financial sector through the Banking Act, the Finance Companies Act, the Development Loans Act, the Local Treasury Bills Act, and the Insurance Act, as well as the two laws mentioned above. The MAS exercises stringent oversight over financial institutions in Singapore, and has broad discretion in licensing local and foreign financial institutions to operate in the republic. MAS also serves as Singapore's de facto central bank, and is responsible for formulating and implementing Singapore's monetary policy.

The MAS provides a variety of licenses for the securities industry. Besides generally stipulating that the "licensees" must be of good character, knowledgeable, and credit-worthy, the SIA and the FTA give the MAS broad powers to "vary any condition or restriction or impose further conditions or restrictions," in granting the licenses.

The Securities Industry Council (SIC), created by the original SIA, still advises the Minister of Finance on all matters relating to the securities industry. The SIC is a bipartite body made up of representatives appointed from the private sector by the Minister of Finance. The SIC also has regulatory power to investigate transgressions and summon any person to provide information accordingly. The SIC acts in close coordination with the MAS.

The Equity Markets: The Stock Exchange of Singapore

Singapore's equity market is comprised of five sub-markets organized under the umbrella of the Stock Exchange of Singapore (SES). In descending order of size, the five markets are:

- the Main Board, the largest and primary market;

- the CLOB International, an over-the-counter (OTC) market for international stocks;

- the SESDAQ, a secondary stock exchange trading in shares of small and medium-sized corporations;

- the Debentures, Bonds, Loans and Transferable Subscription Rights (DBL & TSR) Market; and

- the Stock Options Market.

The SES was incorporated in 1973 after Singapore and Malaysia terminated parity between their two currencies and dissolved their common stock exchange. Until the mid-1980s, the SES was a small player in the international equity market. It was restrictive and characterized by lethargic, labor intensive trading, inefficient operations, and undercapitalized brokerage houses that provided few professional services such as research or analysis.

When the economic difficulties of the SES-listed Pan Electric Industries in 1985 threatened the solvency of several brokerage houses that had overtraded for their own accounts and overfinanced their customers' margin buying, the SES closed the exchange for three days and the MAS arranged a guaranteed "life boat" line of credit from Singapore's four largest local banks. To restore credibility to the market, the government made the SES increase the paid-up capital and adjusted net capital[1] requirements for member firms to a minimum of S$10 million (US$6.2 million) and S$3 million (US$ 1.9 million), respectively, and capped aggregate indebtedness to five times adjusted net capital. New rules mandated reserve funds, margin requirements for margin trading, and limits on exposures.

The SES Main Board is dominated by large Singapore government-linked corporations, but the exchange hopes to encourage more listings by locally incorporated subsidiaries of multinational corporations. As of the end of January 1994, the SES Main Board listed a total of 205 companies, including 27 foreign companies, with a market capitalization of S$225.8 billion (US$139.4 billion). About one-quarter of this capitalization came from the listing of the mammoth former government monopoly, Singapore Telecom. Eleven percent of Singapore Telecom, worth S$4.2 billion (US$2.6 billion) was sold in the initial offering. At the end of January 1994, two-thirds of the listed stocks had been given "trustee" status by the Central Provident Fund (CPF — a national pension fund), which allows individual Singaporean investors to use their CPF savings to purchase "trustee" equities. Liberalized rules on the use of CPF savings contributed to the bull market of 1993.

The SES opened the Central Limit Order Book (CLOB) International in January 1990 after the Malaysian government cut the last links between the Kuala Lumpur and Singapore stock exchanges by prohibiting the listing of shares on both exchanges. The split reduced trading on the SES by 55 percent in volume and cut market capitalization by 45 percent. About 60 percent of Singapore's daily trades now take place on this over-the-counter exchange. As of the end of January 1994, CLOB International quoted 126 stocks (including 113 Malaysian, 10 Hong Kong,

[1] Adjusted net capital is defined as shareholders' fund less non-current assets, deficits in clients' accounts, diminution in the value of own investments, and related items.

one Philippine, one Indonesian, and one European counters) with a total market capitalization of S$151.9 billion (US$93.8 billion). The number of NASDAQ counters available in the CLOB has fallen from 35 in 1988 to 25 at present. Trading in these stocks is very light due to their high price compared to local shares.

The DBL & TSR market is tagged to the Main Board and SESDAQ. A total of 211 debentures, bonds, loans and TSRs were listed at the end of January 1994, with a market capitalization of S$195.9 billion (US$81.4 billion). Turnover on the Main Board, the CLOB, and the DBL & TSR markets has risen by an annual average of 53 percent since 1990 to reach 1.2 billion units in 1993, while the value of transactions increased by 52 percent in the period to reach S$134.3 billion (US$83.9 billion).

The government launched the SESDAQ in February 1987 to allow small and medium-sized firms that the market views as having a higher risk but good growth potential to raise capital. SESDAQ is modeled after New York's NASDAQ. There are currently 37 stocks traded on the SESDAQ with market capitalization of S$3.5 billion (US$2 billion).

As of January 1994, 363 companies with a total market capitalization of S$578 billion (US$356 billion) were listed on the various equity markets. The growth of offshore banking activities and the influx of foreign capital (mainly Japanese as the yen appreciated) has fueled rapid growth in the equity markets since the late 1980s. Growth appears to have peaked in 1993 when a run on the SES pushed turnover volume up by 372 percent.

The SES set up the stock options market in March 1993. There are currently 102 call and put options on only four stocks in this fledgling market.

Foreigners are generally free to invest in local equity and debt instruments. Foreign shareholdings are limited in local companies in the sectors of defense, domestic full license banking and mass media, and in some companies in which the government is the principal shareholder. In these categories allowable foreign shareholding ranges from 40 to 49 percent.

SES Membership

Under the supervision of the MAS, the SES sets its own criteria for membership and listing, and regulates the activities of its members. The SES Committee, which runs the exchange, is made up of four stockbrokers elected from the membership and five individuals appointed by the Minister of Finance. One of the five appointed members is also appointed as SES's executive chairman.

The SES is owned by its 33 members, of which 16 are 100 percent Singapore-owned, 10 are joint ventures with foreign partners, and seven are wholly foreign-owned "international members," a new category established in 1990.

Current SES policy limits foreign ownership of domestic member firms to 49 percent equity. In 1987, the SES announced that it would accept applications for joint ventures with up to 70 percent foreign ownership — with final SES action on the applications contingent on meeting certain criteria during three years of operation. Nine firms applied, of which two gained membership, three disbanded their partnerships, and four have not requested final SES approval. In 1990, when the SES instituted the international member category, it closed the 70 percent joint venture category. All new joint ventures are subject to the 49 percent limit.

Although there is no ownership limitation on "international members," international members must trade in lots of greater than S$5 million when executing transactions for residents of SES-quoted securities denominated in Singapore dollars. For transactions of non-SES-quoted securities, international members may freely transact orders of any size with residents and nonresidents. Nor are there restrictions for trades of SES-quoted shares with nonresidents. However, international members are not eligible to vote in elections for, nor can they be elected to, the SES Committee — although currently one international member is appointed to the SES Committee.

The seven international members (four Japanese, two British, and one French) joined the SES in 1992. There is no cap on the number of local or international members the SES can accept. However, no local, full memberships have been approved by the SES since 1986. The SES has considerable discretion in approving or denying applications for membership, and it tends to focus on larger, better established firms (the SES only approved seven out of 10 applicants for international member status in 1992).

SES rules do allow for an "associate" membership. Associate status may be granted to nonmembers wishing to deal in securities quoted in a securities market established by the SES for the quotation of securities other than Singapore dollar-denominated securities quoted on the Main Board. There are currently no associate members on the SES, however.

In addition to the above firms, 44 other securities firms, including a number of foreign firms and foreign joint ventures, are licensed to operate in Singapore. These firms can trade only in SES-listed securities through member firms. However, they are free to trade in non-Singapore dollar SES-quoted securities without dealing through member firms.

Unit Trusts and Funds

Unit trusts and funds are similar to mutual funds in the United States. Their importance has grown over the last decade as their increasing variety has attracted a growing number of local investors, particularly risk-averse small investors. Unit trusts and funds are regulated under the Singapore Companies Act by the Ministry of Finance's Registry of Companies and Businesses. Trustees are screened and approved by the Minister under the Companies Act.

As of the end of March 1994, local and foreign financial institutions offered 56 unit trusts and 20 funds in Singapore. U.S.-based mutual fund companies may not market their funds to Singapore residents, but there are no barriers to foreign-owned financial institutions offering Singapore-based unit trusts and funds. Six unit trusts, managed by four local banks and two foreign investment institutions have "trustee" status, allowing them to tap into the Central Provident Fund government-mandated savings program for Singapore's citizens. The CPF board has the power to grant trustee status. (The initial public offering of Singapore Telecom in October 1993 illustrated the potential market for "trustee" securities — Singaporeans withdrew S$4 billion (US$2.5 billion) from their CPF accounts to purchase shares in the former government monopoly.)

The Financial Futures Market: SIMEX

The government, looking for niches in the financial services industry, established the Singapore International Monetary Exchange (SIMEX) as Asia's first financial futures market in 1984. Developed out of the former Gold Exchange of Singapore, SIMEX also continues to provide commodity futures contracts in gold and oil. As of the first quarter 1994, there were a total of 13 futures contracts and 5 options contracts available on SIMEX. SIMEX does not trade futures on any commodity other than energy and gold contracts. Rubber contracts are currently traded on the Trade Development Board's Singapore Commodity Exchange (SICOM), formerly the Rubber Association of Singapore Commodity Exchange. SICOM intends to begin offering contracts in commodities such as coffee and palm oil in the near future.

SIMEX modeled its open outcry trading system, its regulations, and other aspects of its market operations after the Chicago Mercantile Exchange (CME.) To ensure a sufficient volume of transactions and liquidity, SIMEX also has joined in a "mutual offset system" (MOS) with the CME, which enables a position opened in one exchange to be offset or closed in the other without having to pay an additional margin to the other exchange. MOS allows for round-the-clock trading. Given the international outreach, SIMEX remains open even on local public holidays.

SIMEX is governed by the Futures Trading Act of 1986 and is supervised by the MAS, but it exercises its own strict financial requirements and screening processes in admitting new traders and regulating their activities. The requirements are transparent and do not discriminate in any way between local and foreign traders. U.S. and other foreign traders dominate the futures market, with about 80 percent of the 15.7 million contracts traded on the exchange in 1993 taken by overseas clients.

Floating rate instruments, derivatives, and other new financial products are readily offered in Singapore by both foreign and domestic traders without restriction. The MAS encourages development of greater financial product and technological sophistication. However, both foreign and domestic banks must obtain approval from the MAS before introducing any new type of financial product, but individual approval is not necessary for product lines already

approved by MAS. Particularly in the derivatives market, the MAS has taken a cautious approach in granting new product approvals. The derivatives market in Singapore has been growing slowly.

Singapore Government Securities

The Singapore government, with regular budget surpluses and foreign reserves of S$77.9 billion (US$48 billion), does not currently issue securities to finance expenditures — although the government recently announced its intention to make the government and government-linked companies more reliant on the securities market for future borrowings. The MAS issues securities under the Government Securities Act and the Development Loans Act as debt instruments to regulate liquidity in the money market and to provide financial institutions with investment instruments to meet reserve requirements. The government restructured its debt market in 1987 to develop a more active and liquid secondary market, and to allow interest rates to reflect market conditions. Government-set interest rates were abolished and a weekly auction system modeled after the U.S. Treasury auctions was adopted.

MAS regularly issues its securities in the form of bonds with maturities of two, five, and seven years, and Treasury bills of three, six, or twelve months maturity, to the public through seven primary dealers who act as market makers and provide two-way quotes. Two of the three foreign primary dealers are U.S.-owned. There are no discriminatory barriers for foreign participation in this market. MAS also issues nonmarketable government debt to the CPF board. In 1993, MAS issued government bonds totaling over S$16.2 billion (US$10 billion). Average daily turnover in Singapore government securities in 1993 reached S$367 million (US$227 million), while daily repurchase agreements averaged S$162 million (US$100 million).

Merchant Banks

The 77 merchant banks in Singapore are important players in Singapore's securities industry. In addition to underwriting securities issues and providing investment management services, the merchant banks also engage in interbank lending, domestic and offshore loan syndication, gold and foreign exchange trading, mergers and acquisitions, and provide corporate finance and advisory services. Thirty percent of total merchant bank assets worth S$42.2 billion (US$26 billion) in 1993 were in securities. Their activity in raising new capital for private sector firms and issuing new debt securities such as bonds, debentures and loan stocks, rose by 20 percent to S$1.8 billion (US$1.1 billion) in 1993.

Foreign-owned merchant banks generally establish in Singapore as locally incorporated subsidiaries. Merchant banks must be approved by MAS. Although they do not obtain licenses under the Banking Act, their Asian Currency Units (ACUs) must comply with Banking Act requirements (ACUs are foreign curency transactions.) To obtain permission from MAS to operate as a merchant bank in Singapore, a financial institution's Head of Office must be

established as a bank, merchant bank, securities firm, or investment house. MAS reviews applications on a case-by-case basis and is likely to approve only the larger, better established applicants.

Merchant banks can raise funds from shareholders or borrow from other financial institutions. Sixty-five percent of their funds are raised in the interbank market with the remainder from nonbank customers. They do not need to maintain statutory reserve and liquidity requirements. Merchant banks may operate Asian Currency Units, which have the same rights as the ACUs of commercial banks and must meet Banking Act requirements.

U.S. PRESENCE IN THE MARKET

U.S. firms account for 11 out of 45 non-SES brokerages, including one that is 100 percent owned by Bank of America. However, U.S. companies own equity in only two SES members, and cannot gain controlling interest due to SES restrictions on equity ownership above 49 percent in regular SES members. No U.S. firm has elected to join the SES as an "international member."

U.S. companies have a significant presence in Singapore's merchant banking industry, which plays a key role in the development of Singapore's equities markets. U.S. firms owned controlling interests in nine merchant banks in 1993.

There also is a strong U.S. and foreign presence in Singapore's financial futures market. Eight of the 38 corporate clearing members are U.S.-based. One is a joint venture with a local firm. Another U.S. firm is among the 34 non-clearing members. Three of SIMEX's 12 commercial associate members are U.S. firms. The U.S. presence, however, is not strong in the individual member and trading permit holder categories. Only nine of the 525 individual members and trading permit holders are U.S. residents. The figure would be slightly higher if those U.S. members who have taken permanent residency in Singapore were also included. Most U.S. customers trade through U.S.-based members of the SIMEX. Presence in this market is limited only by the availability of seats. Due to space constraints, and the fact that current members want the value of their seats to appreciate, SIMEX is not offering new slots. Prospective traders must seek seats through the open market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign securities firms, including U.S. companies, have the same right to establish and offer financial products as do domestic firms with respect to government securities, unit trusts, merchant banking, and financial futures. Introducing new financial products generally requires government approval.

SES regulations restrict foreign equity ownership of SES regular members to 49 percent. Although SES international members can be 100 percent foreign owned, they cannot vote in elections for the SES Committee.

In 1987, the SES announced it would allow up to 70 percent equity for joint ventures meeting specific criteria. Of the nine companies that applied for that status, only two requested 70-percent equity after the three-year trial period. Three joint ventures disbanded and the remaining four have not asked the SES for action to increase foreign equity. This category was supplanted by the international membership in 1990. No U.S. securities firm has elected to join the SES as an international member. International members of the SES are subject to a restriction on the size of lots they must trade when executing transactions for residents of SES-quoted securities denominated in Singapore dollars (this restriction applies to all international members; IMs, however, are exempt from several prudential requirement relating to exposure to a single client and exposure to a single security, which the MAS argues puts IMs in a better competitive position vis-a-vis SES members).

Foreign securities firms may freely offer to domestic residents domestically managed unit trusts and funds. They may offer foreign mutual funds to residents if the necessary prospectuses are registered with the Singapore Registrar of Companies.

Residents face no capital controls or restrictions in obtaining offshore financial instruments for investments. Similarly, there are no restrictions on local companies, except local financial institutions, in issuing securities or notes in overseas markets. However, prior approval from the MAS is required. Foreign companies can participate in underwriting foreign issues made by local companies without restriction. There are restrictions on access to and issuance of offshore Singapore dollar-denominated securities.

TAIWAN

BANKING

SUMMARY

Taiwan has taken a number of steps in recent years to liberalize its banking sector. Taiwan lifted a ban on the establishment of new domestic banks in July of 1989, and a prohibition on new credit cooperatives in November 1993. As a result, many new banking offices have been established, reducing the average number of persons served by each banking office to around 4,000 in 1993 from over 4,700 in 1990. During this period, outstanding bank deposits and bank loans surged 61 percent and 82 percent, respectively. The number of automatic teller machines almost tripled. And credit cards and ATM cards in circulation more than tripled.

However, despite the banking sector's rapid growth the banking community is still dominated by a handful of Taiwan's large, state-owned banks that account for nearly one-half of the country's banking offices and two-thirds of its banking assets.

Foreign banks are marginal participants in traditional deposit-taking and bank lending activities. The 17 offices operated by 11 U.S. banks in Taiwan represent less than just 0.4 percent of all deposit-taking offices, and account for just 0.7 percent of outstanding deposits and 1.3 percent of outstanding loans. However, foreign banks have made significant inroads in foreign exchange and trade related activities, accounting for 20 percent of foreign exchange trading, holding 25 percent of foreign exchange deposits and export loans, and over 90 percent of advances on imports. There are 2.4 times more U.S. credit cards in circulation than local credit cards.

Treatment for U.S. banks has improved since the 1990 National Treatment Study, but discriminatory practices still remain. In June 1994, Taiwan partially lifted the ban on foreign investment in local banks; however, a 5 percent equity limit applies to foreign and domestic investors alike. In August 1994, Taiwan announced the easing of certain criteria for bank branch entry, the immediate elimination of geographical and numerical restrictions on bank branching, and the reduction of the waiting period between establishment and branching from five years to two years. Taiwan also announced the elimination of the ceiling on banks' acceptance of New Taiwan dollar deposits. The limit on NT dollar loans for a single customer was relaxed for U.S. banks in January 1992, while the limits on NT dollar and foreign currency loans for a single customer for local banks were tightened in September 1993.

In the foreign exchange market, restrictions on foreign exchange liabilities terms and the taking of long- and short-positions represent important constraints on U.S. banks' ability to fund their activities. As a result, foreign banks are forced to rely on the volatile and often illiquid interbank market. These restrictions also limit trading volume in the foreign exchange market. Taiwan allows only limited non-trade related NT dollar forward contracts. Foreign banks are subject to limits on commercial paper guarantees that are not applied to domestic banks.

DESCRIPTION OF THE MARKET

Taiwan has traditionally maintained very tight control over its banking system. By far the most important of the commercial banks are the "domestic banks," which control more than 50 percent of assets and dominate the Taiwanese financial system. Until 1991, there were 16 domestic banks, of which all but four were either government-owned or government-controlled. The four private institutions accounted for a mere 8.4 percent of total bank deposits in 1991, whereas the six banks owned by provincial governments held over 77 percent of total deposits.

Following the lifting of the longstanding ban on new domestic banking licenses, 16 new banks were established in 1991 and 1992. Each of the new banks was required to have minimum capital of NT$10 billion and is owned and operated by a private conglomerate. Each new bank could initially operate a maximum of seven offices and was allowed to open five additional offices in each subsequent year. In addition to the 16 new banks, a trust and investment company was reorganized into a commercial bank in 1993. Collectively, these new banks operate more than one hundred new offices.

Despite this gradual liberalization, the commercial banking system is still dominated by state-owned banking institutions. There are 78 commercial banks in Taiwan. In addition to the domestic banks, there are 37 branches of foreign banks and 8 medium business banks. Fourteen commercial banks are owned by local authorities. These 14 institutions account for 51 percent of bank offices and 74 percent of bank deposits and loans. They are the major credit suppliers to state-owned and small private enterprises, providing over 90 percent and 80 percent of loans for these two borrowers, respectively.

Taiwan's banking system has expanded significantly since 1990. Outstanding deposits rose 61 percent to NT$10.48 trillion, while outstanding loans grew 82 percent to NT$8.43 billion by year-end 1993. During these three years, the number of operating offices of commercial banks surged 45 percent and those of community banking institutions rose 10.7 percent.

Although the scope of dishonored checks in 1993 reached an eight-year high (0.54 percent of total number and 0.39 percent of total face value of total checks cleared), all state-owned and private domestic commercial banks reported profits before tax in the year (11 of 37 foreign banks reported losses).

Postal Savings System

In addition to government-run banks, the government also controls the Postal Savings System (PSS). The PSS has the largest deposit-taking network in Taiwan, comprising 1,585 offices spread geographically throughout Taiwan. Postal savings offices exceed the number of combined commercial bank offices. The PSS operates 1,495 ATMs and takes in 15.5 percent of deposits outstanding. The PSS, however, is not allowed to extend loans. All deposits into

PSS must be redeposited with "designated" commercial banks under the tight control of the Central Bank of China. Foreign banks can be designated.

Community Banks

Taiwan has many community banking institutions, including 74 credit cooperative associations and 312 credit departments belonging to farmers' and fishermen's associations. In general, these institutions are small and subject to many restrictions. They are organized on the basis of membership rather than as incorporated companies. They can take deposits and offer loans, but only to their members. They may not engage in trust business and are not permitted the full range of foreign exchange trading allowed to commercial banks. As of the end of 1993, they had one-third of total banking offices, received 25 percent of outstanding deposits, and held 19 percent of outstanding loans. Their assets of NT$3 trillion represented 16 percent of the banking system's total assets.

An important financial liberalization took place in November 1993 when the Credit Cooperative Law (CCL) was enacted. This new law lifted a 21-year ban on setting up new credit cooperatives, allowed the extension of their operations beyond a county, let credit cooperatives accept a limited number of small business firms as quasi-members, and permitted them to upgrade to commercial banks when their capital reached NT$10 billion.

Trust Banks

There were seven trust and investment companies operating 60 branches throughout Taiwan at year-end 1993. They accounted for 2.4 percent and 3.2 percent of all banking institutions' assets and outstanding loans, respectively. They may not take any kinds of deposits, although they are permitted to raise and manage trust funds. They can extend only medium to long-term loans. They may invest in securities, and they may provide underwriting and brokerage services in the securities market.

Offshore Banking Units (OBUs)

Offshore Banking Units (OBUs) provide for the foreign currency needs of foreign and domestic financial institutions. By the end of 1993, a total of 38 offshore banking units (OBUs) were operating in Taiwan. Among them, 19 were run by domestic banks and six were run by U.S. banks. The combined assets of the OBUs at the end of 1993 were US$26.8 billion, 13 percent more than in 1992. Deposits by banking institutions and borrowing accounted for 90 percent of their capital funds, i.e., 60 percent from foreign financial institutions, 22 percent from domestic financial institutions, and 8 percent from inter-OBU sources. The OBUs re-deposit over 70 percent of their funds, although lending to non-residents has been growing rapidly and was up 17 percent in 1993.

Financial Products

Despite this expansion in banking presence, competition for corporate finance has intensified as financial instruments other than bank loans have become more readily available. The bills market has been steadily increasing in importance as a short-term capital source for business. In 1992 the finance authorities opened the secondary bills market to banks, and in August 1994, permitted the establishment of new bills finance firms. According to the Ministry of Finance timetable, banks will be permitted to enter the primary market in August 1995.

In addition, issuance of commercial paper has become a very significant alternative source of funding to loans. Outstanding commercial paper (CP), as of the end of 1993, amounted to NT$3.87 trillion, more than double the NT$1.73 trillion outstanding in 1990. This outstanding CP was equivalent to 46 percent of total outstanding loans extended by all banking institutions at the end of 1993, compared to 37.3 percent in 1990.

Deposit Insurance

Deposit insurance exists for commercial banks, community banking institutions, and trust and investment companies, but it is voluntary. Less than 40 percent of these institutions have chosen to participate.

ATMs/Credit Cards

Credit cards in circulation in Taiwan more than tripled, rising to 2.05 million by the end of 1993. The number of ATMs and ATM cards tripled to 6,672 sets and 20.87 million cards, respectively. The number of ATM cards now approximates the entire population of Taiwan.

Overseas Activities of Taiwanese Banks

Taiwanese commercial banks have also expanded their overseas offices. They had 69 overseas branches and representative offices at the end of 1993, up 72.5 percent from their total in 1990. During this period, their offices in the United States rose from 15 to 21, while those in Asia jumped from 12 to 22.

U.S. PRESENCE IN THE MARKET

Among the 37 foreign banks in Taiwan at the end of 1993, 11 came from the United States. These 11 U.S. banks operated 17 of the 53 banking offices run by foreign banks in Taiwan. They also had 6 of the 19 offshore banking units established by foreign banks.

As deposit-taking and loan extending institutions, U.S. banks have a small role. They represent only 2.3 percent of the 465 deposit-taking institutions on the island. Their 17 operating offices accounted for less than 0.4 percent of the 4,752 offices run by all deposit-taking institutions.

They took in only 0.7 percent of outstanding deposits and held just 1.3 percent of outstanding loans. Foreign banks altogether have set up only 16 automatic teller machines (0.2 percent of the total), and they have issued only 58,034 ATM cards (0.3 percent of the total).

Conversely, U.S. banks dominate the credit card business. Since Taiwan opened the credit card market in 1989, U.S. credit cards (including Visa, American Express, MasterCard and Diners Card) in circulation have increased dramatically, rising from 120,000 cards in 1989 to 1.45 million cards in 1993. This is 2.4 times the number of local cards issued and managed by local banking institutions. In 1992, the Bureau of Monetary Affairs lifted the monopoly privilege enjoyed by the United Credit Card Processing Center. In 1993, two new credit card processing centers were set up, of which one is operated by a U.S. firm.

Foreign banks also have captured a significant share of the foreign exchange and trade related business. In 1993, foreign banks occupied a very substantial market share in this area, i.e., 20 percent of foreign exchange trading, 29.6 percent of outstanding export loans, 25.8 percent of outstanding foreign exchange deposits, and 92.4 percent of advances on imports.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Technically, foreign banks can enter Taiwan in branch form by investing in local banks or by establishing a new locally incorporated bank. This reflects a recent improvement. In June 1994, Taiwan lifted the ban on foreign investment in local banks. In the same month, the Ministry of Finance (MOF) also extended permission for foreign banks to acquire shares in local banks that are not listed on the Taiwan Stock Exchange. However, for both foreign and domestic participation, individual equity ownership is limited to just 5 percent, and shareholding by related groups is limited to 15 percent unless approval from the Ministry of Finance has been obtained. MOF has confirmed that a 100 percent foreign-owned bank can be established, but only through the participation of numerous unrelated individuals and/or groups. Potential investors must submit their applications during the period from May 12 to October 11 of every year.

A foreign bank applying to establish a branch in Taiwan must demonstrate that it has not violated banking or other laws in foreign countries in the three prior years. An applicant must also either: (1) rank among the world's top 500 banks in terms of assets or capital (net worth); or (2) have conducted transactions with Taiwanese banks or major enterprises amounting to at least $1 billion in the three calendar years prior to application, among which not less than $180 million must have been medium- or long-term credits. Exceptions to the world ranking or minimum business contact requirements are provided in the following instances: (1) where a foreign bank has merged with another foreign bank that already has established a branch in Taiwan; and (2) where a foreign bank intends to establish a branch in Taiwan in order to take over the assets and liabilities of a branch of its subsidiary bank. In August 1994, Taiwan dropped previous criteria that had required applicants for entry to have a 10-year track record

for transactions with Taiwanese banks or business enterprises, or to have operated a representative office in Taiwan for one year.

Foreign banks with assets ranking among the top 1,000 in the world are permitted to buy equity shares in domestic banks listed on the Taiwan Stock Exchange (Taiex). However, they are subject to the equity limitations of 5 percent for individual and 15 percent for related investors, as discussed above.

In August 1994, Taiwan announced the lifting of geographical and numerical restrictions on foreign bank location and branching. The guidelines announced also reduced the waiting period between the establishment of the original branch and the establishment of additional branches from five years to two. This two-year waiting period may be waived for the same reasons that Taipei grants exceptions to the bank entry criteria — i.e., in cases of merger or when a parent takes over the assets and liabilities of a subsidiary. The two-year waiting period is onerous to foreign banks and is not imposed on domestic banks.

Under the revised guidelines, the minimum capital requirement for the first branch of a foreign bank has been raised from NTD 80 million to NTD 120 million. Foreign banks now operating in Taiwan will be allowed a transition period to raise their capital to these new requirements.

Foreign banks may apply to set up an offshore banking unit (OBU). In 1993, Taiwan extended permission to set up OBUs to foreign banks that do not have a commercial presence in Taiwan. Also in 1993, Taiwan lowered the world ranking criterion for applicants to set up an OBU from the top 150 worldwide to the top 500 worldwide in terms of assets.

Despite these additional entry channels, only five foreign bank branches were set up in 1990, four in 1991, and three each in 1992 and 1993, far less than the number of branches established by domestic banks — 43, 50, 166, and 170 — in these four years, respectively.

Taiwan lifted the 20 percent foreign ownership limit for bills finance companies in October 1993, and in August 1994, allowed the establishment of new bills finance companies. Foreign investors may acquire equity shares in the three bills finance companies, but they are subject to the above-mentioned 5/15 percent ownership limits.

Foreign ownership in investment and trust companies also is subject to the 5 and 15 percent ownership limitations. Taiwan is in the process of transforming the existing seven trust and investment companies into commercial banks. No foreign membership is allowed in community banking institutions.

Operations

In August 1994, Taiwan announced the removal of the limit of 15 times local capital on a foreign bank's NT dollar deposits. Domestic banks had not been subject to this discriminatory ceiling. At the same time, Taipei raised bank minimum capital requirements. Foreign banks can import capital, but they are not allowed to raise capital locally by issuing bank debentures. Only four specialized domestic banks (the Chiao Tung Bank, Land Bank of Taiwan, Farmers Bank of China, and Medium Business Bank of Taiwan) may issue bank debentures. Foreign branches can guarantee commercial paper only up to 10 times their net worth, while local banks are not subject to any limit in this regard.

Different standards are used to calculate the limits on lending to a single customer for domestic and foreign banks, but they generally favor foreign banks. For a foreign bank, total NT dollar loans for a single customer (a natural person or a corporate entity) may not exceed 10 percent of the bank's total lending portfolio or NT$1 billion, whichever is higher. For foreign banks, total foreign currency loans to a single customer may not exceed 25 percent of the net worth of the foreign bank's head office in its home country. So far, the lending of U.S. banks has not reached the ceiling, but the limits may become a constraint in the future as the scale of business of U.S. firms expands. For domestic banks, the limit on NT loans is 3 percent for individuals and 15 percent for juridical persons. Loans with a term of over one year may not exceed the total fixed-term deposits of a bank, and residential construction loan exposure may not exceed 20 percent of savings deposits.

On the foreign exchange market, Taiwan sets limits on domestic and foreign banks long and short positions based on their business volumes. The short positions are US$10 million for each of the five largest domestic banks (including International Commercial Bank of China, Bank of Taiwan, Changhwa Commercial Bank, Huanan Commercial Bank, and First Commercial Bank) and US$6 million for each of the other domestic banks and all foreign banks. The long positions are US$50 million for the five largest domestic banks and US$20 million for all other domestic banks and all foreign banks.

Taiwan sets individual long-term foreign exchange liability limits for different banks, principally based on their portfolios of foreign currency borrowing. The foreign exchange liability limits have been raised from time to time when banks have pressed against them. However, these limits — as well as long and short positions — restrict banks from developing their own foreign exchange business. Those on foreign exchange liabilities also reduce banks' ability to raise funds abroad, which is often important for foreign banks that have not cultivated a domestic deposit base.

The three domestic bills finance corporations — Chung Hsing, Chung Hua, and International — are the only authorized underwriters in the primary money market in Taiwan. These corporations are majority-owned by Taiwan's largest state banks. The secondary bills market for dealing and brokerage business was opened to domestic and foreign banks in May 1992.

Most domestic banks are licensed to broker property insurance although they cannot broker life insurance. Foreign banks are not specifically prohibited from brokering property insurance, but no foreign bank has applied.

FINANCIAL MARKET DISCUSSIONS

Since the spring of 1988, the Treasury Department has held periodic discussions with Taiwan's monetary and financial authorities, under the auspices of the American Institute in Taiwan, on matters of concern to the U.S. financial services industry. In addition, as Taiwan seeks GATT/WTO entry, Treasury has been negotiating for substantial improvements in the environment for foreign financial institutions in Taiwan. Since the initiation of these bilateral talks, Taiwan has gradually improved the treatment for foreign financial institutions. Some of the more important changes implemented in recent years are listed below:

- Limits on foreign banks' ability to take NT dollar deposits were eliminated and the limit on NT dollar loans to a single customer was increased from NT$500 million to NT$1 billion, thereby meeting specific commitments made during bilateral consultations.

- In May 1992, Taiwan permitted domestic and foreign banks to engage in bills trading and brokerage business, although domestic and foreign banks were barred from the primary market.

- In August 1993, Taiwan permitted the establishment of foreign exchange brokerage companies. Foreign ownership in the brokerage companies may not exceed 50 percent for individuals or in aggregate. In contrast, each domestic bank is subject to an ownership limit of 10 percent, and all other domestic investors 20 percent, in the brokerage companies.

- In December 1993, Taiwan opened NT dollar interest rate swaps to domestic and foreign banks.

- In January of 1994, a U.S. bank was permitted to set up its own credit card processing center, ending the monopoly of the credit card processing business by the United Credit Card Processing Center.

- In March 1994, Taiwan opened all foreign currency financial products (including foreign exchange swaps, interest rate swaps, forward rate agreements, margin trading, cross currency interest rate swaps, OTC currency options, caps, floors, and collars) to domestic and foreign banks.

- In June, the finance authorities lifted a ban on foreign banks' investment in local banks and establishment of subsidiaries or joint ventures.

- In August 1994, the authorities permitted the establishment of new bills finance firms and set a timetable that will allow banks to do business in the primary market in August 1995.

Despite these piecemeal steps towards liberalization, a number of significant discriminatory practices still prevent foreign financial institutions from effectively competing with domestic financial firms. Stringent review of application procedures and limitations on establishment of wholly-owned subsidiaries prevent foreign banks from entering the market and expanding their presence at a pace comparable to that of domestic banks. Further, operational ratios are tied to remitted-in, rather than parent, capital. Such factors, together with limits on foreign exchange liabilities, banks' short and long positions, and on commercial paper guaranty, continue to put foreign banks at a disadvantage in competition with domestic banks. The Treasury Department will continue to address these problems bilaterally and in the context of Taiwan's accession to the GATT/WTO.

Taiwan's Financial System
December 31, 1993

Institution (m.)	Number of Head Offices	Domestic Branch Offices	Assets (US$ m.)	Liabilities (US $ m.)
1. Central Bank of China	1	0	2,991	2,846
2. Commercial Banks				
Domestic Banks	33	1,030	13,604	13,050
Foreign Branches	37	16	850	828
U.S.	(11)	(6)	(302)	(292)
Others	(26)	(10)	(548)	(536)
Medium Business Banks	8	352	1,625	1,569
3. Community Bank Institutions				
Credit Cooperative Associations	74	482	1,770	1,701
Credit Department of Farmers' and Fishermen's Associations	312	822	1,243	1,199
4. Investment and Trust Companies	7	60	618	560
5. Postal Savings System	1	1,585	1,714	
6. Insurance Companies				
Non-life Insurance Companies	23	83	56 (net)	
Domestic	15	n/a	n/a	
U.S.	8	n/a	n/a	
Life Insurance Companies	28	67	698 (net)	
Domestic	14	n/a	n/a	
U.S.	14	n/a	n/a	
7. Finance Companies				
Fuh-Hwa Securities Finance Co.	1	2	124	115
Bills Finance Companies	3	21	657	629
8. Others				
Central Deposit Insurance Corp.	1	0	7 (net)	
Offshore Deposit Insurance Corp.	38	0	27 (net)	
Domestic	19	0	n/a	
Foreign	19	0	n/a	
U.S.	6	0	n/a	
Others	13	0	n/a	

TAIWAN

SECURITIES

SUMMARY

Since the beginning of 1993, Taiwan has intensified efforts to liberalize its securities market. The limit on the number of branches permitted for foreign securities firms has been lifted (previously only three firms were permitted to open single branches), and the "qualification requirement" to establish only branches has been eliminated. Foreign securities firms are now allowed to establish subsidiaries that can perform all of the same securities services that local securities firms can perform (i.e., brokerage, dealing, underwriting, and securities financing). Capital and other regulatory requirements for establishing foreign securities subsidiaries are identical to those for local securities subsidiaries. In addition, restrictions on securities investment by foreign institutional investors have been relaxed, thus making it easier for non-residents to engage in portfolio investment in Taiwan.

Nonetheless, the U.S. presence in Taiwan's securities markets is very limited, except for a handful of securities investment and trust companies (SITCs) and offshore futures brokerage firms. Of Taiwan's 272 securities firms, U.S. firms have a limited ownership in just three. In addition, just one U.S. securities company operates a branch, and just four maintain representative offices. Moreover, foreign institutional investors, let alone U.S. investors, still account for less than just 1 percent of total securities trading volume.

Discriminatory treatment still restricts the U.S. presence in Taiwan. Foreign institutional investors are subject to investment fund limits, ownership limits in listed companies, and profit repatriation restrictions. Individual foreign investors may not trade in Taiwan's securities markets. And ownership limits are imposed on foreign investment in securities investment and trust companies and domestic brokerage firms engaging in offshore futures brokerage business.

DESCRIPTION OF THE MARKET

Securities Firms

As of December 31, 1993, a total of 272 companies with 189 branch offices (in addition to their head office) were engaged in some form of securities business in Taiwan (as of August 31, 1994, the numbers were 266 and 208, respectively). Among these 272 companies, 254 were engaged in brokerage activities, 68 were engaged in securities dealing, and 57 were engaged in securities underwriting. Many of the local firms were engaged in more than one type of business.

Among the 272 local securities firms, 11 were joint ventures with foreign securities companies, with foreign ownership ranging from less than 1 percent to 40 percent. Only one foreign

securities company maintained a branch in Taiwan, while 15 had representative offices. (The number of foreign representative offices rose to 19 in early April 1994.)

Securities Investment and Trust Company (SITC)

Apart from the 272 securities companies, there are 15 Securities Investment and Trust Companies (SITCs). All 15 have some foreign ownership; 8 have some U.S. ownership. A SITC issues beneficiary certificates for raising securities investment trust funds and actively invests in securities by using a securities investment fund.

SITCs have issued six Taiwan funds on foreign stock exchanges, 30 local funds for trading on the Taiwan Stock Exchange, and four local funds for trading in foreign securities on overseas markets. All mutual fund business is reserved for SITCs. A bank or securities firm that intends to create and manage mutual funds in Taiwan must set up a subsidiary SITC to do so.

Applications to open a new SITC are received each year during the period October 1-31.

Securities Investment Consulting Company (SICC)

In addition, there are 87 Securities Investment Consultant Companies (SICCs) — 19 have some foreign ownership, of which three have some U.S. ownership. An SICC receives remuneration for its securities investment consulting services. SICCs may only perform the following services:

- provide research, analysis, or advice, on a commission basis, on matters related to investment in securities (including foreign securities);

- publish material relating to securities investment activities;

- conduct seminars in connection with securities investment; and

- perform other relevant securities investment consulting activities as approved by the Securities and Exchange Commission.

Among the 87 SICCs, 25 were permitted to provide consultant services for local investors to trade in 325 overseas mutual funds approved by the SEC. SICCs may not serve as brokers in the transaction of foreign or domestic mutual funds. These functions are reserved for SITCs.

Securities Finance Companies

Securities Finance Companies, of which there are currently 43, provide credit to buyers of securities and lend securities to "short sellers" of securities transactions. These activities are permitted only on the stock exchange. Only a broker whose net worth reaches NT$800 million and who has been in operation for at least two years may provide securities finance. The broker's total loans to securities buyers must not exceed 1.5 times its net worth. The value of securities lent to sellers must not exceed 75 percent of its net worth. Until recently, a broker could not provide other brokers with securities refinance, because the Fu-Hwa Securities Finance Co., had a legal monopoly (three of the four newcomers to this market are now in the process of setting up offices).

None of the Securities Finance Companies has foreign ownership, although foreign ownership is not prohibited.

Offshore Futures Brokerage

The Offshore Futures Transaction Law, which went into effect in 1993, has made it possible to engage in limited futures trading. The SEC approved applications for the establishment of 23 offshore futures brokerage firms in October and December of 1993. Local investors will be permitted to trade in futures products (including commodity and financial futures products) via these brokerage firms on 11 foreign markets in the United States, England, France, and Singapore. Taiwan's first futures broker started operating in April 1994.

To prepare for opening offshore futures trading, the SEC approved applications of 14 local offshore futures brokerage firms in October 1993 and the establishment of nine foreign futures brokerage firms in December 1993. One of these firms, Grand Cathay Futures, began operations in April 1994. Seven of the nine foreign firms are American. Products that may be offered include interest rate futures, major market index and commodity futures, and currency futures.

In 1993, the Ministry of Finance began permitting domestic and foreign banks to offer NT dollar interest rate swaps and forward rate agreements. A bank intending to do business in these and other new derivative products is required to acquire prior approval from the Bureau of Monetary Affairs within the MOF. In March 1994, the Central Bank of China authorized both domestic and foreign banks to offer foreign currency derivative products.

The introduction of new financial products is limited to banks, however. Domestic and foreign securities firms are limited to brokering and dealing in listed securities (equity shares and bonds). There are no stock index options or stock futures contracts presently permitted.

Taiex and OTC Markets

Securities can be traded either on the Taiwan Stock Exchange (Taiex) or in the over-the-counter (OTC) market. The latter is regulated by the Securities Dealers Association (TSDA). For equity shares, a company must choose between either of the two markets; bonds may trade in either market concurrently. In practice, bonds generally trade on the OTC market and equity shares trade on the stock exchange.

Market Statistics

As of August 31, 1994, a total of 293 companies listed 337 issues of stock on the Taiex. Over 9,461 million equity shares were available for trading, and the listed companies had paid-in capital of NT$962 billion. The listed shares had a combined market capitalization of NT$5,143.6 trillion at the end of August 1994.

Also listed on the Taiex were 35 issues of public bonds valued at NT$708 billion, 29 issues of corporate bonds valued at NT$14 billion, and 20 issues of mutual funds that had 9,119 million beneficiary certificates with a total market value of NT$111.9 billion available for trading.

Listed on the OTC market were 11 companies whose equity shares had a total market value of NT$9.6 billion, 35 issues of public bonds with a market value of NT$708 billion, and 20 issues of corporate bonds with a market value of NT$35.2 billion. (Note: public bonds listed on the OTC are also listed on the Taiex when they are issued. Corporate bonds are listed either on the Taiex or on the OTC market.) Four local companies have issued global depository receipts (GDRs), but no foreign company has issued Taiwan depository receipts (TDRs) in Taiwan.

In 1993, eight new public bonds were issued. Only one corporate bond was added to the OTC market in 1993, while 10 corporate issues were added to the Taiex. Twenty-nine companies listed 39 new issues of equity shares on the Taiex in 1993. Issues from these newly listed companies, as well as issues from over 150 other companies, resulted in an increase of NT$15.5 billion in equity shares on the stock exchange, a 21-percent jump.

In terms of market value, listed bonds accounted for just 12.8 percent of total securities listed on the Taiex and the OTC market at the end of 1993. In terms of trading, however, bonds were more dominant. Trading volume in 1993 totaled NT$22,458.1 billion, of which bonds accounted for 58.6 percent, equity shares 40.3 percent, and mutual funds only 1.1 percent. Bonds began to dominate securities trading in 1992 when they rose sharply from under a quarter of volume to over one-half. The growth in bond trading is attributed mainly to a sharp increase in the issuance of public bonds to finance public construction projects in the last several years.

Annual trading volume on the Taiex in 1993 totaled NT$9,056.7 billion, of which equity shares accounted for 97 percent, mutual funds 2.6 percent, and bonds just 0.4 percent. By contrast, bonds accounted for 99.99 percent of total trading on the OTC market. Nearly all of the bonds traded were public bonds, with very few corporate bonds and bank debentures traded.

Regulation

The Securities and Exchange Commission (SEC) is the official regulatory agency under the jurisdiction of the Ministry of Finance. The SEC Chairman has a rank below that of a Vice Minister. The SEC has six divisions that oversee securities issuance, securities firms regulation, securities trading and market regulation, and inspection and auditing.

There are two self-regulatory agencies, the Taiwan Stock Exchange (Taiex) and the Taipei Securities Dealers Association (TSDA). The Taiex, operating the only centralized securities trading market, is organized in the form of a corporation, with 39 percent ownership held by state-run financial institutions and enterprises. The Taiex is responsible for preliminary review of all listing applications, clearing and settlement, and examining operations and financial conditions of securities brokers and dealers.

Before floating equity shares or corporate bonds on the OTC market, companies are required to register with the TSDA, an agency formed by securities dealers engaged in OTC trading and brokerage. Four specialized banks (including the Chiao Tung Bank, Land Bank of Taiwan, Farmers Bank of China, and the Medium Business Bank of Taiwan) may have their financial debentures traded on the OTC market once they are registered with the TSDA. Public bonds are automatically listed on the Taiex and the TSDA as soon as they are issued.

Investors

As of August 31, 1994, a total of 650 accounts engaged in securities trading (equity shares and bonds) on the Taiex. Individuals accounted for 94 percent of securities trading in 1993, compared with 5.5 percent for domestic corporate investors and 0.6 percent for foreign institutional investors.

Foreign individuals continued to be prohibited from accessing securities on the Taiex. However, Taiwan reportedly plans to permit foreign national persons to acquire shares of a local company through purchases of convertible bonds in the future. In addition, a U.S. national may indirectly own equity shares of Taiwan companies by acquiring beneficiary certificates of "Taiwan funds," a mutual fund variant listed on a U.S. stock exchange, or other mutual funds that invest in companies listed on the Taiwan Stock Exchange. Another indirect way to access Taiwanese securities is to acquire global depository receipts (GDRs), or convertible bonds issued by Taiwanese companies.

Nondiscretionary Foreign Exchange Trust for Investment in Foreign Securities

As previously described, an SICC may provide consulting services for investment in foreign securities, but it may not trade in such securities on behalf of clients. To facilitate a client's investment in foreign securities, an SICC must work with a bank and a broker in a foreign

country where the client will invest. The client then enters into a "nondiscretionary trust agreement" with the bank that will convert the local currency into foreign currency for investment in designated foreign securities through the foreign broker. The bank also serves as a custodian for the SICCs client. This arrangement is necessary because in Taiwan only banks can remit foreign exchange.

U.S. PRESENCE IN THE MARKET

The U.S. presence in Taiwan's securities market is small. Among the 272 securities firms in Taiwan at the end of 1993, only three had any U.S. ownership. The U.S. interest in each of the three securities firms was less than five percent. One U.S. securities company operated a branch, but it was engaged only in securities trading on the New York Stock Exchange on behalf of local clients. Three of the 15 foreign representative securities offices are U.S. firms.

In January 1994, one additional U.S. securities company established a representative office in Taiwan. As of June 30, 1994, the presence of U.S. securities firms in Taiwan included four representative offices and one branch.
U.S. firms have a presence only in peripheral securities businesses and in offshore futures brokerages, however. Eight of the 15 Securities Investment and Trust Companies have some U.S. ownership, ranging from 5 percent to 24 percent. According to the SEC, many of the 325 overseas mutual funds approved by the SEC for local investors to trade in under the arrangement of non-discretionary foreign exchange trust for investment in foreign securities were U.S. mutual funds. Foreign ownership is absent from the 14 domestic brokerage firms permitted to do offshore brokerage. However, nine foreign firms have been permitted to set up branches for futures brokerage, and seven of these are from the United States.

Foreign institutional investors' share of securities trading was only 1.6 percent in December 1993, and it fell to 0.75 percent in February of 1994. (Note: The SEC could not identify trading by U.S. institutional investors. As of December 31, 1993, U.S. foreign institutional investors brought in US$334.6 million of investment funds, which represents only 13 percent of the US$2.6 billion remitted in by all foreign institutional investors.) Only a few of Taiwan's 87 Securities Investment Consultant Companies have any U.S. investment.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Before July 1993, only three foreign securities firms could establish branches in Taiwan. These branches faced discriminatory capital requirements and other restrictions. From July 1993 to February 1994, restrictions on branching in Taiwan were eased; foreign firms wishing to establish branches in Taiwan no longer have to be in the top 10 in assets in their home country, and they no longer face discriminatory capital requirements. The time required to upgrade a representative office to a branch was lessened from two years to one year (domestic firms do not have a similar waiting period). In January 1994, all foreign ownership restrictions were abolished; U.S. firms may now create 100 percent-owned subsidiaries, and they may now engage freely in joint ventures.

Foreign and domestic firms face the same capital requirements and, after establishment, may provide essentially the same services (including brokerage, dealing, underwriting, and securities financing). Furthermore, U.S. securities firms may provide brokerage services for local investors to deal in foreign securities, while local securities firms may not. Specifically, foreign firms may broker securities (equity shares and bonds) listed on the New York, London, and Tokyo stock exchanges on the condition that their parent companies are a member of the exchange. They may not, however, broker foreign securities listed on stock exchanges other than the above-mentioned three exchanges or securities traded in foreign OTC markets. Such limitations have constituted a constraint for foreign branches in developing their business in Taiwan. However, domestic securities firms may not broker and trade foreign securities at all in Taiwan.

U.S. firms may participate in underwriting offshore issues from Taiwan companies, as long as they have underwriting experience and enter into an underwriting cooperation contract with a local underwriter. Such issues include bonds and global depository receipts (GDRs). Offshore issuance of bonds was opened before 1991, while the issuance of GDRs began in April 1992. In March 1994, the Bank of China set a limit for all offshore bonds convertible into the NT Dollar and for GDRs at US$3 billion.

U.S. securities firms continue to face discriminatory treatment in several areas, however. U.S. (and other foreign) institutional investors are subject to a US$200 million individual investment limit and a US$7.5 billion aggregate investment limit. In addition, foreign institutional investors are subject to restrictions on repatriation of capital and earnings. Concerning shares of individual listed Taiwanese companies, foreign institutional investors are subject to two limits: (1) 5 percent of equity per individual institutional investor and (2) 10 percent of equity for all foreign institutional investors combined. These limits may be lifted with special, case-by-case approval from the Foreign Investment Commission. Local investors are not subject to such limits.

Among foreigners, only "qualified foreign institutional investors" are permitted to invest in Taiwanese stock. Foreign individuals are prohibited. A qualified foreign institutional investor

must obtain SEC approval, and it must be (1) one of the top 3,000 non-communist banks, or (2) an insurance company with $US 500 million or more in assets, or (3) a fund manager with $US 300 million or more in assets, or (4) a securities company with net worth of $US 150 million or more or previous experience with Taiwanese securities. Taiwan has stated that it will review its policy of prohibiting non-institutional foreign investors.

In addition, foreign individuals may not hold equity and debt instruments listed on the exchange.

Foreign ownership in a Securities Investment and Trust Company is subject to two limits: (1) no single foreign investor may own more than 25 percent of a SITC's shares and (2) total foreign ownership may not exceed 49 percent.

Foreign ownership in domestic brokerage firms engaging in offshore futures brokerage business is subject to two limits: 10 percent for a single foreign investor and 40 percent for all foreign investors combined.

Only Taiwanese companies may list their stocks on the Taipei Stock Exchange.

Taiwan authorities ask local and foreign financial institutions to comment on proposed new rules or changes to existing rules. Very often, however, only a few foreign financial institutions have such an opportunity.

FINANCIAL MARKET DISCUSSIONS

Since the spring of 1988, the Treasury Department has held periodic discussions with Taiwan's authorities, under the auspices of the American Institute in Taiwan, that have dealt with the concerns of the U.S. financial services industry. Since then, Taiwan has gradually improved the treatment for foreign financial institutions. In 1994, as negotiations for Taiwan's entry into the GATT/WTO intensified, Treasury sought specific commitments from Taiwan to allow a significantly enhanced role for foreign securities firms in the Taiwan market.

In June 1992, the SEC began allowing the issuance of TDRs and GDRs, thereby enabling local companies to raise capital funds abroad and foreign companies to raise funds in Taiwan.

The limits on investment in Taiwanese securities by individual foreign institutional investors were eased on several occasions, from US$50 million to US$100 million in August 1993, and to US$200 million in November 1993. The limit for combined investment by all foreign institutional investors was raised from US$2.5 billion to US$5 billion in August 1993, and to US$7.5 billion in March 1994.

Restrictions on the repatriation of the principal of foreign institutional investment capital were relaxed in November 1993. Non-trade related capital inflows and outflows by an individual are subject to $5 million per year. Amounts above this amount require prior approval. The limit for firms has been raised to $10 million per year.

Qualification requirements for foreign institutional investors to trade on the Taiex have been relaxed. In January 1993, the minimum period that a foreign fund must be in existence before it can invest in Taiwan was reduced from five to three years, and the minimum amount that a foreign fund must manage before it can invest in Taiwan was lowered from US$500 million to US$300 million.

In July 1993, the SEC abolished the "limit of three" that had been placed on the number of foreign securities firms that were allowed to establish a securities branch office in Taiwan. Also eliminated at this time was the very strict eligibility requirement that a foreign securities firm must rank in the top 10 in its home country in terms of assets in order to be admitted. In its place, the SEC established the requirement that a firm must have a representative office in Taiwan for two years before upgrading to a branch office.

The SEC expanded the permissible activities for a branch from "brokerage only" to include dealing, underwriting and securities financing; essentially the same activities that local securities firms are permitted to undertake.

Capital requirements were reduced from US$2 billion to NT$0.2-1.0 billion for the parent company overseas, and from NT$200 million to NT$100 million for the branch doing brokerage business in Taiwan. Capital requirements related to provision of specific services are identical to those for local firms.

In January 1994, the SEC lifted the limit on foreign ownership in a local securities firm. A foreign securities firm may now establish a 100-percent owned subsidiary, or enter into a joint venture arrangement with local partners without any ownership restriction.

In February 1994, the required length of time before a foreign representative office can upgrade to a branch was shortened from two years to one year.

In May 1994, Taiwan lifted the ban against establishing new securities finance companies. There is no longer any quota or restriction on foreign ownership.

In June 1994, MOF waived ownership limits on investors intending to set up new securities finance companies.

In August, the SEC approved the upgrade of eight foreign securities firms from representative office to branch. Included among the eight was one U.S. firm, Goldman Sachs. No other U.S.

firm with a representative office applied. (The application period for an upgrade runs from June 1 to July 31 of each year.)

Despite these positive steps, the overall environment for securities firms operating in Taiwan remains restrictive. Capital and exchange controls impede their range of operations, as do limitations on foreign institutional investors and the outright ban on individual portfolio investment. Also, the prohibition on wholly foreign owned securities investment trust companies remains a significant barrier. Treasury will continue to address these and other problems in the context of negotiations regarding Taiwan's GATT/WTO accession.

THAILAND

BANKING

SUMMARY

Commercial banks have traditionally dominated deposit taking in Thailand. However, the rapid development and growing sophistication of the Thai economy and its associated financial system has eroded the importance of banks in intermediating many financial flows and has significantly impacted bank operations. While commercial bank deposits continue to grow in real terms, they accounted for only 37 percent of the financial system's assets in 1993. This represents a halving of their share compared to only seven years ago. Powerful forces of modernization, globalization and competition are changing the banks from principally deposit takers and loan makers to broader institutions whose income increasingly is derived from a new array of financial services.

There are 29 commercial banks in Thailand — 15 domestic and 14 foreign, including four American institutions. This number has been static, as no new banking licenses have been issued since 1978. In addition, there are 43 representative offices of foreign banks in Thailand, of which 14 are from the United States. Twenty-two of these foreign representative offices have received licenses to operate offshore banking units under the new Bangkok International Banking Facility (BIBF), as have 12 of the 14 foreign commercial banks already operating in Thailand and all 15 domestic banks.

Domestic Thai banks account for about 93 percent of commercial bank assets with the remaining 7 percent accruing to foreign banks. The U.S. bank share is approximately 1.8 percent. Other financial institutions in Thailand include three government banks and numerous nonbank financial institutions, principally finance companies, life insurance companies and cooperatives.

The Ministry of Finance has broad responsibility for financial sector policies, while the Bank of Thailand is more directly involved in bank supervision.

Foreign banks can generally engage in the same activities as domestic banks, but they are disadvantaged in a number of respects. They are prohibited from opening additional branches. Although they are allowed to join the national ATM pool, foreign banks must receive approval from the pool's members. Foreign banks also are required to maintain minimum capital funds of 125 million baht (about 5 million U.S. dollars) invested in low yielding government securities. The number of expatriate management personnel is strictly limited, which limits foreign banks' operations. However, foreign banks are not subject to some directed credit requirements that apply to domestic banks.

Thai finance officials have indicated that they plan a gradual liberalization that will open the financial system to more competition, including competition from foreign banks. Thai financial policymakers cite concern over trade-offs between increased efficiency through competition on

the one hand, and the stability of the financial system on the other as a major factor in the pace of liberalization.

DESCRIPTION OF THE MARKET

Structure of the Market

Formal commercial banking in Thailand began in 1888 when Hong Kong and Shanghai Banking Corporation began operation, followed by Standard Chartered Bank in 1894 and Banque de l'Indochine in 1897. The first domestic bank opened in 1904, eventually becoming the Siam Commercial Bank. Commercial banks in Thailand are governed by the Commercial Banking Acts of 1962 and 1979, amended in 1985 and 1992. Licenses are issued by the Ministry of Finance, but no new banking licenses have been approved since 1978.

There are now 29 commercial banks operating in Thailand, 15 domestic and 14 foreign. At the end of 1993, the banking industry employed 117,008 people nationwide, in 2,714 branches. There are 1,762 ATMs in Thailand.

Commercial bank activity dominates deposit taking in Thailand. At the end of 1992, domestic and foreign commercial banks held about two-thirds of all the assets of deposit taking institutions. This share is believed to have been approximately the same at the end of 1993, when bank assets totalled $130 billion. However, commercial bank deposits, while continuing to grow in real terms, have fallen dramatically as a percentage of total financial assets, to 37 percent in 1993 compared to over 70 percent in 1986. In particular, high returns from stockholding led to a significant shift in the composition of financial portfolios and to sizable flows into equity markets.

Other banking institutions in Thailand include the Government Savings Bank, the Bank for Agriculture and Agricultural Cooperatives (BAAC) and the Government Housing Bank. These other banking institutions held assets at the end of 1993 worth US$14.0 billion, 7.4 percent of the financial system's assets.

At the end of 1993, nonbank financial institutions included 91 finance companies, 16 credit foncier companies (which finance the purchase of real estate), the Industrial Finance Corporation of Thailand, the Small Industries Finance Corporation, 12 life insurance companies, 1,977 agricultural cooperatives, 965 savings cooperatives, and 367 pawnshops. Nonbank financial institutions accounted for 33 percent of financial institutions' assets at the end of 1993, valued at US$30.7 billion.

Thai law seeks to limit excessive concentration of shareholdings in Thai banks. No person is permitted to acquire more than 5 percent of the issued shares of a domestically incorporated

bank. However, the 5 percent limit does not apply to shares held by the government. The Ministry of Finance, the Crown Property Bureau, and the Royal Thai Army are major investors in several Thai banks. The government retains an ownership interest in 10 of its 15 commercial banks, and in four it is the largest shareholder. Major private shareholders have not been forced to divest shares in excess of 5 percent, but they are not allowed to add to their holdings. Thus, some Thai banks remain in the effective control of wealthy Thai-Chinese families. Foreign shareholders are subject to the 5 percent limit on individual shareholdings in domestically incorporated banks as well as to aggregate limit of 25 percent of a bank's shares. Foreign nationals are limited to 25 percent of the directorships of Thai banks. Most foreign investment in Thai banks is channeled through mutual funds.

In 1992, the effective lending rate for commercial banks was 13.2 percent and the effective deposit rate was 9.2 percent, giving an effective spread of 4.0 percent. The effective spread for commercial banks has varied from 2.96 percent to 4.0 percent since 1987. The maintenance of fairly wide spreads has contributed to very strong profits for domestic banks, as has expansion into other business lines. Net profits for domestic commercial banks in 1992 stood at US$1.2 billion, up 60 percent over the year before.

Thai financial authorities established the Bangkok International Banking Facility (BIBF) to meet the growing and increasingly complex financing needs of the Thai economy and to promote Thailand as a regional financial center. In March 1993, the Ministry of Finance and the Central Bank issued 47 licenses to commercial banks to operate offshore banking units under the BIBF. All 15 domestic banks, 12 of the 14 foreign commercial banks already operating in Thailand, and 22 other foreign banks with representative offices in the country received BIBF licenses. By June 1994, 42 banks had begun operations in the BIBF. These banks generated US$12.7 billion in onshore lending of foreign exchange, with foreign banks accounting for 47 percent of this total. International lending totalled US$5.3 billion dollars, with foreign banks accounting for 80 percent of the total. The offshore banking units are limited in their operations and, until recently, essentially prohibited from lending in local currency. However, according to a recent announcement by Thai authorities, the offshore units will be allowed to open provincial branches that can extend credit in local currency up to 20 billion baht per branch.

In 1954, a Thai bank opened its first overseas commercial branch. At the end of 1993, 11 Thai commercial banks were operating 43 overseas branches, 28 of which were in Asia. At the end of 1993, Thai banks operated five agencies and six branches in the United States.

Banking Regulation

The Ministry of Finance has broad responsibility for financial sector policies, while the Bank of Thailand is more involved in day-to-day supervision of banks.

Thailand has undertaken considerable liberalization of its financial markets. In 1990, the Bank of Thailand lifted foreign exchange controls. Later the requirement to register foreign borrowings was eliminated. Thai nationals were permitted to invest a maximum of $5 million abroad without prior approval, Thai individuals and companies were allowed to hold foreign currency deposits with local commercial banks and banks were allowed to accept nonresident baht accounts. In June 1992 the Bank of Thailand rescinded the ceilings on deposit and loan rates, generally allowing the market to set interest rate levels. However, the government has also engaged from time-to-time in "jawboning" pressure to reduce lending rates to smaller borrowers and generally reduce spreads between borrowing and lending rates.

Commercial banks are now permitted to diversify into new lines of business, such as underwriting of debt instruments, marketing of mutual fund units, securitization, custodial services and the management of private funds.

Thai authorities are gradually adopting the capital adequacy standards generally in accord with those proposed by the Basle Committee. As of April 1, 1994, Thai banks were required to maintain a capital to risk-weighted assets ratio of at least 7.5 percent; foreign banks must maintain local capital equal to at least 6.5 percent. Beginning January 1, 1995, the ratio will be raised to 8 percent for Thai banks and 6.75 percent for foreign banks.

There is no formal government or private sector deposit insurance in Thailand. The Ministry of Finance provides financial assistance and managerial expertise to troubled banks through the Financial Institutions Development Fund. This fund and its predecessor fund have rescued several banks and finance and securities companies.

U.S. PRESENCE IN THE MARKET

Four of the foreign commercial banks with domestic operations in Thailand are branches of U.S. banks: Citibank, Chase Manhattan Bank, Bank of America, and Bank of America (Asia) Ltd. (The latter was formerly Security Pacific Asian Bank.)

The U.S. banks have a significant portion, approximately one-third, of total deposits held by foreign banks. Citibank has the largest deposit base of any foreign bank. However, U.S. and other foreign banks remain relatively small players in traditional deposit taking and lending business relative to domestic Thai banks.

All four have received licenses to operate offshore banking units in the BIBF. Three other American banks, Bankers Trust, American Express Bank Ltd and Bank of New York, also have received licenses to operate units in the BIBF. At least one other American bank has expressed interest in the possibility of applying for a BIBF license.

An additional 14 U.S. banks maintain representative offices in Thailand.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks, seeking to enter Thailand are currently unable to do so because of the moratorium on new onshore licenses. This also affects potential Thai applicants. Those foreign banks that have already established in Thailand are subject to a number of restrictions on expansion. They are limited to one office and are not permitted to operate offsite ATMs, which are considered additional branches.

Foreign banks also are required to maintain minimum capital funds of 125 million baht (about 5 million U.S. dollars) invested in low yielding government securities and other eligible papers. This counts towards fulfillment of capital to risk ratios. Although foreign banks are now allowed in theory to participate in the existing ATM network, they have been unable to negotiate satisfactory agreements with the domestic banks that control the ATM network. Branches of foreign banks are not subject to some directed credit requirements that apply to domestic banks.

The number of expatriate management personnel is strictly limited to six persons, which also hampers foreign banks' expansion. Banks that operate BIBF affiliates are allowed to have two additional expatriate personnel. U.S. bankers have cited the lack of qualified managers as a problem that prevents upgrading services. The adverse effect of this restriction is heightened by the difficulty many banks, domestic and foreign, have in hiring and retaining qualified Thai personnel in Bangkok's booming and highly competitive labor market.

All 15 of the domestic banks belong to the Thai Bankers Association (TBA), which presents banks' views to the government on financial issues and has cooperated in the drafting of banking legislation. However, TBA membership is limited to banks incorporated in Thailand and foreign banks, which are all established in branch form, are not permitted to join.

Thai authorities have announced a plan to allow foreign banks participating in the BIBF to open two offices outside the Bangkok metropolitan area. Thai officials have not yet provided full details, such as any limitation on the types of services offered in the new branches. However, the offshore units will be allowed to open provincial branches that can extend credit in local currency up to 20 billion baht per branch. In addition, Thailand's offer in the General Agreement on Trade in Services in the Uruguay Round includes allowing up to five foreign

banks participating in the BIBF to undertake full bank branch business by 1997. The method by which these banks will be chosen is not clear.

Otherwise, foreign banks can engage in generally the same activities as domestic banks.

Deposits of Domestic Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Deposits	Market Share (percent)
1. Bangkok Bank	23,244	24.21
2. Krung Thai Bank	14,492	15.09
3. Thai Farmers Bank	13,929	14.51
4. Siam Commercial Bank	10,266	10.69
5. Bank of Ayudhya	6,577	6.85
6. Thai Military Bank	5,899	6.14
7. First Bangkok City Bank	4,500	4.69
8. Bangkok Bank of Commerce	3,780	3.94
9. Siam City Bank	3,757	3.91
10. Bangkok Metropolitan Bank	3,464	3.61
11. Bank of Asia	1,761	1.83
12. Thai Danu Bank	1,532	1.60
13. Union Bank of Bangkok	1,223	1.27
14. Nakornthon Bank	1,014	1.06
15. Laem Thong Bank	578	0.60
Total	96,016	100.0

Credits of Domestic Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Credits	Market Share (percent)
1. Bangkok Bank	25,244	25.99
2. Thai Farmers Bank	14,010	14.42
3. Krung Thai Bank	13,239	13.63
4. Siam Commercial Bank	9,704	9.99
5. Bank of Ayudhya	6,739	6.94
6. Thai Military Bank	5,844	6.02
7. First Bangkok City Bank	4,865	5.01
8. Siam City Bank	3,847	3.96
9. Bangkok Metropolitan Bank	3,502	3.61
10. Bangkok Bank of Commerce	3,433	3.53
11. Bank of Asia	2,201	2.27
12. Thai Danu Bank	1,612	1.66
13. Union Bank of Bangkok	1,249	1.29
14. Nakornthon Bank	1,140	1.17
15. Laem Thong Bank	498	0.51
Total	97,127	100.0

Assets of Domestic Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Assets	Market Share (percent)
1. Bangkok Bank	30,919	25.27
2. Thai Farmers Bank	17,441	14.25
3. Krung Thai Bank	16,782	13.71
4. Siam Commercial Bank	12,839	10.49
5. Bank of Ayudhya	7,939	6.49
6. Thai Military Bank	7,638	6.24
7. First Bangkok City Bank	6,027	4.93
8. Siam City Bank	4,966	4.06
9. Bangkok Bank of Commerce	4,778	3.90
10. Bangkok Metropolitan Bank	4,435	3.62
11. Bank of Asia	2,755	2.25
12. Thai Danu Bank	2,019	1.65
13. Union Bank of Bangkok	1,634	1.34
14. Nakornthon Bank	1,452	1.19
15. Laem Thong Bank	750	0.61
Total	122,374	100.0

Deposits of Foreign Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Deposits	Market Share (percent)
1. Citibank	529	23.0
2. Bank of Tokyo	404	17.6
3. Hong Kong & Shanghai	326	14.2
4. Standard Chartered Bank	316	13.8
5. Sakura Bank	282	12.3
6. Banque Indosuez	95	4.1
7. Deutsche Bank (Asia)	91	4.0
8. Chase Manhattan Bank	79	3.5
9. Bank of America	63	2.7
10. Bharat Overseas Bank	36	1.6
11. Intl. Comm. Bank of China	30	1.3
12. United Malaya Banking Corp.	18	0.8
13. Four Seas Bank	15	0.6
14. Security Pacific Asian Bank	11	0.5
Total	2,295	100.0

Credits of Foreign Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Credits	Market Share (percent)
1. Sakura Bank	1,335	21.6
2. Bank of Tokyo	1,276	20.6
3. Citibank	965	15.6
4. Hong Kong & Shanghai	591	9.6
5. Standard Chartered	422	6.8
6. Bank of America	379	6.1
7. Deutsche Bank (Asia)	376	6.1
8. Banque Indosuez	347	5.6
9. Chase Manhattan Bank	279	4.5
10. Intnl. Comm. Bank of China	60	1.0
11. Security Pacific Asian Bank	57	0.9
12. Four Seas Bank	40	0.7
13. Bharat Overseas Bank	34	0.6
14. United Malayan Banking Corp.	23	0.4
Total	6,184	100.0

Assets of Foreign Commercial Banks in Thailand
Year-End 1993
(millions of dollars)

Bank	Assets	Market Share (percent)
1. Sakura Bank	1,531	19.6
2. Bank of Tokyo	1,443	18.5
3. Citibank	1,283	16.5
4. Hong Kong & Shanghai	711	9.1
5. Standard Chartered Bank	675	8.7
6. Bank of America	595	7.6
7. Deutsche Bank (Asia)	470	6.0
8. Banque Indosuez	432	5.5
9. Chase Manhattan Bank	332	4.3
10. Security Pacific Asian Bank	93	1.2
11. Intl. Comm. Bank of China	78	1.0
12. Four Seas Bank	56	0.7
13. Bharat Overseas Bank	50	0.6
14. United Malayan Banking Corp.	47	0.6
Total	7,796	100.0

Data in the preceding tables is from the Bank of Thailand, as reported by Thai Farmers Bank)

Thai Financial Institutions
Year-End 1992

	Assets (billions of dollars)	Market Share (percent)	Credits (billions of dollars)	Market Share (percent)
Commercial Banks	99.53	68.0	85.11	72.2
Finance Companies	26.65	18.3	21.76	18.5
Cooperatives	3.65	2.5	3.24	2.8
Govt. Institutions*	13.48	9.2	6.70	5.7
Other (Pawnshops)	.36	0.2	.33	.3
Total	146.33	100	117.96	100

*Does not include commercial banks in which the government has ownership interest.
Source: Bank of Thailand, as reported by the Thailand Development Research Institute

Banks' Share of Financial Assets

	1986		1993 (estimate)	
	Savings (billions of dollars)	Market Share (percent)	Savings (billions of dollars)	Market Share (percent)
Commercial Banks	23.53	70.8	94.47	36.8
Fin. & Sec. Cos.	3.35	10.1	20.62	8.0
Life Ins. Cos.	0.26	0.8	1.33	0.5
Mutual Funds	0.02	0.1	3.42	1.3
Govt. Sav. Banks	3.19	9.6	5.54	2.2
Stock Exchange	2.86	8.6	131.33	51.2

Source: Bank of Thailand and Stock Exchange of Thailand, as reported by Bangkok Bank.

THAILAND

SECURITIES

SUMMARY

The Securities and Exchange Commission (SEC) was established in 1992 to regulate and develop Thailand's securities industry. Under the law, the Stock Exchange of Thailand (SET) is largely self-regulated.

Rapid growth in the Thai economy in the 1980s, accompanied by foreign investor interest and the government's financial liberalization policies, has speeded the development of the domestic equity market. By the end of 1993, the Stock Exchange of Thailand (SET) listed quotations on 347 companies and had a total market capitalization of US$131 billion. By contrast, the Thai bond market is only beginning to emerge. The bond market is still constrained by legal disincentives, a lack of trading infrastructure, and traditional Thai reliance on commercial bank lending to raise capital.

Foreign investment in Thailand via the SET has increased greatly in recent years. Foreign trading turnover on the SET amounted to just over US$10 million in 1982, representing 2.05 percent of the SET's total turnover. By November 30, 1993, foreign investment turnover on the SET amounted to US$24.5 billion, 18.1 percent of total turnover. As of September 1994, there were 10 onshore, and four offshore, mutual funds with investments totalling just over $1 billion.

U.S. securities firms do not have a significant direct presence in Thailand, with only several minority holdings in domestic finance/securities companies. However, U.S. firms have been active in underwriting offshore debt and equity issues by Thai companies over the last three years, and U.S. firms have been involved in the underwriting and management of both offshore and domestic mutual funds.

Foreign firms are limited by law to a minority interest in brokerage and securities firms, and to a 25 percent limit in finance companies (i.e. single companies allowed to do both finance and securities business). U.S. firms can underwrite international issues of Thai companies. Thai investors can invest in foreign securities, but only with the prior approval of the Bank of Thailand.

DESCRIPTION OF THE MARKETS

Regulatory Structure

Two years ago Thailand passed the Securities and Exchange Act of 1992, repealing the 1974 Act and establishing the Securities and Exchange Commission (SEC) as the regulatory authority for

the securities business. In the past, regulatory authority was shared between several agencies and the old Securities Exchange of Thailand.

The Securities and Exchange Act of 1992 allowed limited and public companies to issue debt instruments with the approval of the SEC. The act also provides a more open and flexible legal framework for new securities issues and provides for a full and timely disclosure of relevant information on issuers. Corporate issuers of equity related securities and debt instruments must register with the SEC and provide extensive financial information. The SEC supervises all securities companies; it supervises and approves all primary issues.

Under the 1992 Securities and Exchange Act, the SET was restructured as a nonprofit organization to serve as the secondary market for the purchase and sale of securities. The SET's operations are financed by listing, membership, and securities registration fees. The SET is largely self-regulated, being operated by a board comprised of 11 persons. Five are appointed by the SEC. Five others are selected by the members of the SET. The president is appointed by the 10 other board members. As part of its self-regulating activity, the SET has broad powers to enforce accounting standards and rules against unfair trading practices.

The Bond Market

Thailand's bond market is only emerging (in contrast with its rapidly growing equity market). On the supply side, several factors have worked to stunt the growth of the bond market. In the private sector, businesses have traditionally relied on loans and overdrafts from financial institutions, as well as equity market issues to mobilize funds. Legal obstacles constrained limited companies from issuing bonds. And there was a lack of financial services infrastructure to support market development.

In the public sector, there has been little need to issue debt: the Thai government has run a sizeable budget surplus every year since 1988. Consequently, few new government bonds have been issued in recent years, and the market for government bonds has steadily diminished. In addition, government bonds have been a captive market since regulations require banks to hold a portion of their reserves in government bonds, subject to availability. (Although this regulation is still in effect, it is not strictly enforced at this time.) The effect of the reserve requirement, in turn, has been to reduce the availability of bonds for other private investors.

The Thai government considers the development of the bond market to be a strategic element in the overall development of the financial system. While there is no bond trading system in Thailand, the Ministry of Finance remains quite interested in seeing one established. To this end, the SEC is encouraging securities companies to form a network or "club" of bond dealers to devise a trading system, a quotation convention, a code of conduct, and other necessary support in the development of a secondary market. The system will be market-driven and self-regulated to the extent possible, but will likely require final approval from the SEC before

starting operations. In addition, the SEC plans to devise regulations to protect clients and impose capital adequacy requirements for brokers and dealers. It is also working with the Ministry of Finance's Revenue Department to resolve tax disincentives on bond buyers. Finally the SEC is looking to the development of derivative products over the next two to three years, which would enable bond market participants to hedge risk and therefore increase activity.

On the demand side, tax policies penalize some bondholders and discourage investment in bonds. Trading bonds on the SET is an expensive undertaking, so traders prefer off-exchange transactions. Trading over the counter is not transparent, and price quotations are not standardized.

With government encouragement and cooperation from Standard and Poor's, an independent rating service was formed in 1993, the Thai Rating and Information Service (TRIS). This rating service has had some early success and another rating service may begin operation next year, possibly in cooperation with Moody's or a European service.

As a result, there was a dramatic increase in the number of private bonds issued in 1993 to US$2.4 billion. (The Thai government ran a cash surplus of nearly $3 billion in 1993, so there was no need to issue government bonds.) Only US$400 million were placed under a domestic public offering; US$2.0 billion were private placements, and US$1.2 billion of this amount was sold in foreign markets.

The Equity Market

Securities trading in Thailand has a relatively short history. Companies began acting as intermediaries for securities transactions in 1953, but the volumes were negligible. In 1962, several Thai entrepreneurs and their foreign partners formed the Bangkok Stock Exchange. There were few listings and very little trading on that exchange. After several years of study by the Bank of Thailand, the Securities and Exchange Act of 1974 was enacted and the Stock Exchange of Thailand began operation on April 30, 1975.

In its early years, the SET, like its predecessor, also saw little trading. Spurts of trading activity were based on short term speculation. The fortunes of the Exchange rose and fell with external shocks such as the 1979 oil crisis, worldwide interest rate changes, and government policy shifts.

Securities trading on the SET gathered momentum beginning in 1986. The rapid growth and development of the Thai economy, foreign investor interest, and the government's financial liberalization policies provided momentum for the SET's growth. By the end of 1993, the SET had 347 quoted companies and 22 mutual funds. The total number of listed securities was 408, of which there were common stocks, preferred stocks, debentures, convertible debentures, unit

trusts and warrants. However, common stocks account for nearly all of the SET's market capitalization and turnover.

In 1991, the SET introduced a computerized trading system, developed in cooperation with the Midwest Stock Exchange, called ASSET (Automated System for the Stock Exchange of Thailand). ASSET is a floorless trading system in which brokers enter orders through computers in their offices. The SET has an on-line surveillance system to detect irregular patterns in prices or volumes. The SET also has set up data bases to provide information on quoted companies to investors. Through these systems, the SET seeks to increase the transparency of trading, provide efficiency and fairness for investors, and promote confidence in the SET's operations.

Nevertheless, the system is not yet devoid of the kinds of problems that expose it to disruption, including human error. For example, on November 17, 1993 a sub-broker, apparently by mistake, keyed in an order to sell 88 million shares of a local company that only had 25 million shares registered. The resulting price gyrations reverberated throughout the market. Market surveillance functions of the SET worked, and trading of the stock was suspended almost immediately. However, investor confidence, and therefore the SET index, suffered as a result of this incident.

Thailand has finance companies, securities companies, and a third category of firms known as finance and securities companies (which do both types of business). Thai government authorities have become concerned, for prudential reasons, about the stability of this third category of firms. It is thought that there may be some temptation in this category for the firms to do excessive margin lending to clients of their securities departments. Although there have been no major problems stemming from such a practice, authorities intend to eliminate this third category by requiring firms to be either a securities company or a finance company.

There are 40 broker members of the SET. Foreigners (i.e., juridical persons or corporations that are more than 50 percent owned by foreigners) are prohibited from engaging in the brokerage business in Thailand under the Alien Business Decree of 1972 (National Executive Council Announcement No. 281). The SET is considering allowing some Thai sub-brokers to join the Exchange as full brokers (sub-brokers may take retail orders but must place orders through one of the 40 broker members, and pay a fee). However, the approximately US$14 million entrance fee has deterred potential new members of the exchange. Foreigners are not allowed to be brokers or sub-brokers.

Derivatives Trade and Asset Management

There is no formal futures or options trading in Thailand, although the Thai government appears to be in the preliminary stages of considering the possible creation of a futures market. Pension funds are also almost nonexistent. In fact, pensions are not usually paid to retirees in Thailand. Typically, they get a cash payment on retirement.

Cross-Border Capital Movements

Foreign investors may own shares in listed companies in Thailand only up to the limits specified in various laws or in a particular firm's articles of incorporation. (For example, by law, foreigners can own up to 25 percent of the shares of Laem Thong Bank, but by the bank's own articles, face a limit of only 20 percent.) Foreigners can make purchases of mutual funds that may exceed foreign equity limits, but they cannot exercise voting rights. Repatriation of investment funds, dividends, profits and loan repayments can be made freely, net of all taxes (see below). Commercial banks are authorized to sell foreign exchange for remittance abroad without limit. Thai residents can invest in foreign securities subject to prior approval from the Bank of Thailand.

Thailand also has an Alien Board, which amounts to a separate listing of about one dozen stocks in the newspaper. Issues are listed at higher prices than for issues of the same companies listed on the First or Second Boards, ostensibly as a means of rationing the limited number of shares available to foreigners.

Foreign investment in Thailand via the SET has increased greatly over the years. Foreign trading turnover on the exchange amounted to just over US$10 million in 1982, representing 2.05 percent of the SET's total turnover. By November 30, 1993, foreign investment turnover on the SET amounted to US$24.5 billion, 18.1 per cent of total SET turnover. There are 10 onshore and four offshore mutual funds investing in the SET. The total investment of these funds on the exchange was just over US$1 billion at the end of November 1993.

Individuals are exempt from capital gains taxes and pay a 10 percent tax on dividends and a 15 percent on interest income. Juristic persons pay a 15 percent withholding tax on capital gains and interest income, and 10 percent tax on dividends. Foreign investors from the 26 countries with a tax treaty with Thailand receive varying tax benefits. (The U.S. does not have a double taxation treaty with Thailand.)

U.S. PRESENCE IN THE MARKET

U.S. securities firms do not have a significant direct presence in Thailand, with only several minority holdings in domestic finance/securities companies. Some U.S. securities firms have representative offices in Thailand, such as Merrill Lynch. However, U.S. firms have been active in underwriting offshore debt and equity issues by Thai companies over the last three years and have been involved in the underwriting and management of both offshore and domestic mutual funds. U.S. portfolio investors have been active participants in Thailand's equity market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The Alien Business Decree of 1972 (National Executive Council Announcement No. 272)) restricts foreign firms to a maximum ownership stake of 49 percent in local securities companies. Foreign equity participation in finance companies is restricted to 25 percent. Foreign equity participation in the third category of firms, finance and securities companies, is also restricted to 25 percent. Purchases of shares by foreigners on the SET are limited accordingly. (The U.S.-Thai Treaty of Amity and Economic Relations provides national treatment for all American companies except for enterprises engaged in fiduciary activities and banks involving in depository functions.) There are no restrictions on the activities of firms with minority foreign interests; however, foreigner investors continue to find seats on the SET very expensive (each costs approximately $14 million).

As mentioned previously, Thai authorities intend to segregate the activities of firms known as finance and securities companies for prudential reasons. When the division of is complete there will be new entities available for partial foreign ownership. Foreigners will still be able to own up to 25 percent of the finance companies born of the break-up of finance and securities companies, but will also be able to own up to 49 percent of the securities companies resulting from this change. The difference, in essence, is that foreign investors will be able to own up to 49 percent of an entity which is presently unavailable, due its combination status.

With regard to domestic mutual funds, foreigners are restricted to a 25 percent equity participation. Onshore mutual funds, which are Thai companies, are not subject to foreign shareholding restrictions, even if their capital originates outside the country. However, foreigners cannot exercise voting rights in onshore mutual funds.

Net Investment in Thai Equity Securities, by Country

Country	Millions of Dollars		Percent Share	
	1992	1993	1992	1993
Hong Kong	812.4	401.8	179.2	15.0
Netherlands	25.5	-311.6	5.6	-11.7
Singapore	-72.8	2,006.9	-16.1	75.2
European Union	-276.8	345.2	-61.0	12.9
United States	-27.7	140.2	-6.1	5.2
Taiwan	-3.6	-9.6	-0.8	-0.4
Japan	-45.1	20.9	-9.9	0.8
Others	41.4	76.5	9.1	3.0
Total	453.2	2,670.3	100.0	100.0

Source: Bank of Thailand

Statistical Highlights of the Stock Exchange of Thailand
(millions of dollars)

	1990	1991	1992	1993
Corporate Securities				
Total Yearly Turnover	24,510.8	31,076.3	73,231.1	86,933.2
Turnover by Type				
Ordinary Shares	24,128.3	30,659.2	72,771.8	82,923.1
Preferred Shares	4.8	0.5	1.1	7.6
Unit Trusts	262.8	271.5	331.7	1,139.0
Debentures	21.5	4.4	4.5	43.7
Convertible Debentures	2.9	0.9	0.2	1.6
Warrants	90.5	139.7	121.3	296.5
Number of Companies	209	270	305	347
Number of Mutual Funds	5	6	15	22
Number of Securities	261	318	359	408
Ordinary Shares	209	270	305	347
Preferred Shares	8	8	10	10
Unit Trusts	5	6	15	22
Debentures	31	25	18	17
Convertible Debentures	7	8	8	6
Warrants	1	1	3	6
Total Capitalization				
Par Value	4,030.0	5,755.9	8,054.3	10,710.8
Market Value	23,974.8	35,156.0	58,465.3	131,334.6
Government Securities				
Total Yearly Turnover	2.7	3.0	0.1	0.0
Number of Quoted Issues	126	108	88	64
Total Capitalization (Par Value)	7,197.3	5,505.6	5,221.5	3,928.4
Market Statistics				
SET Index (April 30, 1975 = 100)	612.9	711.4	893.4	1,682.8
Market Dividend Yield (per cent)	3.6	3.6	2.9	2.0
Market P/E Ratio	13.8	15.6	16.3	26.1
Capital Mobilized by Listed Companies	1,753.2	2,179.2	2,177.9	1,219.8

Source: Stock Exchange of Thailand

EGYPT

BANKING

SUMMARY

The Egyptian banking system consists of 69 banks: 4 state-owned commercial banks; 26 joint venture and private sector commercial banks; 11 joint venture investment banks; 20 foreign bank branches; 4 specialized banks; and 3 banks set up under special laws and circumstances. The banking system deposit base and loan portfolio totalled Egyptian pounds (LE) 129.4 billion ($38.6 billion) and LE 67.6 billion ($20.2 billion) respectively, at the end of June 1993. Total assets of banks were LE 198.3 billion ($59.2 billion).

During the period 1957-1974, only wholly Egyptian-owned banks with full or partial government ownership were permitted to operate in the country. Although the banking system has since been opened to private sector banks, the four state-owned commercial banks still dominate the banking market due to their large size in terms of assets, deposit base, and branches. Due to the large number of banks currently operating in Egypt, CBE policy regarding new entrants into the banking market, whether foreign or Egyptian, is very restrictive and no new banks have been licensed recently.

All banks in Egypt are subject to CBE supervision, except the three banks set up under special laws and circumstances. The CBE regulates the banking system by setting reserve and liquidity requirements and guidelines for loan classifications and provisions. The minimum paid-in capital requirement for banks under a 1992 banking law is LE 50 million ($14.8 million). A deposit insurance fund program is being established; however, final regulations have not been enacted. It is believed that membership in the fund will be obligatory for all banks operating in Egypt, including foreign bank branches. Banks are free to set their own interest rates and exchange rates, although the CBE provides informal guidelines, such as T-bill auctions and discount rates.

In 1974, joint venture commercial and investment banks were permitted to be established provided that there was a minimum of 51 percent Egyptian ownership. Additionally, foreign bank branches were permitted to enter the market. However, foreign bank branches were restricted to foreign currency business only until an amendment to the banking law in March 1993, which allowed existing foreign bank branches to engage in local currency operations. Foreign banks operating in Egypt, whether joint ventures or branches, can now engage in the same activities as private Egyptian banks. Foreign banks/branches do not face any constraints in their funding activities and have access to the Central Bank discount window. Both foreign and Egyptian financial institutions comment on the lack of transparency in the banking laws and state that their comments or recommendations are usually not taken into consideration.

The U.S. presence in Egypt includes two American bank branches (Citibank and American Express), one Egyptian-American joint venture commercial bank (Egyptian-American Bank), and an offshore office of Chemical Bank. Citibank and American Express operate in both local and

foreign currencies. Bank of America recently closed its Egyptian branch, a move that grew out of its restructuring plan for its regional operations.

DESCRIPTION OF THE MARKET

Market Structure

The banking system consists of 30 commercial banks (4 government owned-banks and 26 joint venture and private sector commercial banks), 11 joint venture investment and business banks, 20 foreign bank branches (of which 2 are U.S. foreign bank branches), 4 specialized banks, and 3 banks established under special laws and circumstances that exempt them from CBE supervision (Arab International Bank, Chemical Bank and Nasser Development Bank). Sixty-nine foreign and domestic banks currently operate in Egypt with a total of 1,366 branches (excluding village banks). Assets of the banking system totalled LE 198.25 billion (US$59.2 billion) at the end of June 1993. The deposit base totalled LE 129.4 billion (US$38.6 billion), while loans totalled LE 67.6 billion (US$20.2 billion), 52.2 percent of total deposits. As these figures indicate, the Egyptian banking system is highly liquid. Utilizing this excess liquidity is a chief concern of the banking community, as deposit levels are high while loan demand remains very low.

There is little distinction between the different types of financial entities except that investment banks are more willing to take equity positions in companies, while specialized banks focus on specific economic sectors such as industry, agriculture, and real estate. Specialized banks depend on interbank borrowings as a source of finance more than other banks because their deposit base is limited.

The four state-owned commercial banks — National Bank of Egypt (NBE), Bank Misr, Cairo Bank, and Bank of Alexandria — dominate the Egyptian banking sector. As a result of their monopoly of the sector from 1957 to 1974, these banks are the largest and most active in Egypt, with 811 branches. Assets of public sector banks totalled LE 115.4 billion ($34.4 billion), or 58 percent of the Egyptian banking system assets, at the end of June 1993. Their loan portfolio constituted 49.7 percent of the banking system's total loans, while their deposit base was 68.9 percent of the banking system's total deposits. The loan/deposit ratio at the end of June 1993 was 37.6 percent. To improve confidence in the public sector banks and enable them to make provisions for nonperforming loans, the government has started recapitalizing the four state-owned commercial banks.

Egypt has 26 joint venture and private sector commercial banks. The largest joint venture commercial banks are Misr International Bank (MI Bank), Commercial International Bank (CIB), and Egyptian-American Bank (EAB). American Express Bank is the only U.S. bank currently involved in a joint venture commercial bank (with Egyptian-American Bank). Total assets of

joint venture and private sector commercial banks at the end of June 1993 were LE 43.5 billion ($13 billion), or 22 percent of the banking system's assets. Their deposits and loans constituted 22 percent and 23.7 percent of the banking system deposits and loans, respectively.

The country's 11 joint venture and private sector investment and business banks do not yet offer sophisticated investment banking services to the Egyptian market. In large part, this is due to a lack of demand for such services. Although they operate as commercial banks, investment banks provide longer-term loans and credit facilities. Investment and business banks total deposits reached LE 6.5 billion ($1.9 billion) by the end of June, 1993, 5 percent of the total system. Their loans totalled LE 7.7 billion ($2.3 billion), 11.4 percent of the banking system's total loans.

The four specialized banks (the Industrial Development Bank, the Principal Bank for Development and Agriculture Credit, the Arab Land Bank, and the Egyptian Real Estate Bank) are state-owned banks. As their titles indicate, these banks carry out banking operations in support of a specific type of economic activity. For instance, PBDAC supervises 17 agriculture development banks in the country's governorate. Total assets of specialized banks at the end of June 1993 were LE 11.5 billion ($3.4 billion). Their loan portfolio and deposit base totalled LE 8 billion ($2.4 billion) and LE 2.5 billion ($746 million) respectively, 11.8 percent and 1.9 percent of the banking system's total loans and deposits.

Egypt has 784 village banks under the supervision of the Principal Bank for Agriculture Development and Credit (PBDAC). Prior to 1989, PBDAC and the village banks acted as intermediaries between the government and farmers; farmers were obliged to sell their products to village banks at a price fixed by the government. Since 1989, PBDAC and the village banks have started to assume more of a banking role, by providing short-, medium-, and long-term credit facilities for financing harvest and cultivation expenses, purchases of agriculture machinery, and land reclamation projects. These banks are funded through deposits and loans from other banks.

During the period 1957 to 1974, state-owned banks were the only players in the market. The 1956 nationalization campaign led to the sequestration of foreign banks operating in Egypt at that time. Since 1974, foreign banks have been allowed to establish joint venture banks with 51 percent Egyptian ownership. Foreign bank branches were also allowed access to the market, on condition that their operations be restricted to foreign currency. However, in 1992 and 1993, banking regulations permitted existing foreign bank branches to deal in local currency on the condition that their capital be no less than $15 million, or its equivalent in foreign currency.

The Egyptian banking system is highly liquid. Many Egyptians transferred their foreign currency holdings to Egyptian pounds, after the liberalization of the foreign exchange regime in 1991, to benefit from high interest rates. Loan demand is very low due to the current recession. During 1991-1993, most banks invested their extra liquidity in Treasury bills offering

tax-free high interest rates. From a high of 20 percent in 1993, T-bill rates have now settled around 12 percent. Concerned about the budgetary impact of T-bill sales, the government has begun to limit their availability. Other investment instruments include securities, bonds, and mutual funds; however, these products are extremely limited or unavailable. As a result, competition for clients has intensified as banks seek other outlets for this excess liquidity in a recessionary economy.

Market Regulation

The Egyptian banking system is regulated by the Central Bank of Egypt, which determines monetary, credit, and banking policies. As part of its economic reform program, the CBE freed interest rates and foreign exchange rates and tightened prudential banking standards. Primary CBE tools to regulate banking activity include setting liquidity and reserve ratios, establishing loan classification standards, and licensing.

The minimum paid-in capital requirement for banks under a 1992 banking law is LE 50 million ($14.8 million). Reserve requirements are 15 percent of the banks' local currency deposits and 10 percent of foreign currency deposits. Banks' local currency reserves are placed in an interest-free account with the CBE, while foreign exchange reserves placed with the CBE earn interest slightly below LIBOR. Banks are also required to keep 20 percent of their local currency deposits and 25 percent of their foreign currency deposits liquid.

In an effort to rationalize the banking sector, the CBE has begun applying Basle Committee standards for loan categorization. Public sector banks' provisions against bad loans increased significantly in the last few years as a result of the government's decision to no longer guarantee public sector company debt to public sector banks.

The CBE sets its discount rate at 2 percentage points above the average 3-month T-bills interest rate, as determined at a weekly auction. Though the CBE does not regulate interest pricing, banks use the CBE discount rates and T-bills interest rates as indicators. Due to excess liquidity in the system and increased competition among banks, interest spreads between lending and deposit rates have been cut, thus reducing banks' profit margins.

Legislation providing for the establishment of a deposit insurance fund to be managed by the CBE has been passed. Membership in the deposit insurance fund will be obligatory for all banks; however, the fund has yet to begin operations.

U.S PRESENCE IN THE MARKET

There are 20 foreign bank branches operating in Egypt, including 2 U.S. banks: Citibank and American Express. The American banks obtained Egyptian pound licenses in 1993 and now offer a full range of retail and corporate banking services including consulting. A third U.S. bank, Chemical Bank, operates an offshore facility. There is a separate joint venture bank (Egyptian-American Bank) owned jointly by American Express Bank (49 percent) and Bank of Alexandria (51 percent), a state-owned bank. As part of its regional restructuring effort, Bank of America closed its Egyptian office effective October 1, 1994.

Foreign bank branches deposits totalled LE 2.8 billion ($835.8 million), 2.2 percent of total bank deposits at the end of June 1993, while loans totalled LE 2.3 billion ($686.6 billion), 3.4 percent of the banking sector's total loan portfolio.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The 1956 nationalization campaign led to the sequestration of foreign banks operating in Egypt at that time. Since 1974, foreign banks have been allowed to establish joint venture banks with 51 percent Egyptian ownership. Foreign bank branches were also allowed access to the market, on condition that their operations be restricted to foreign currency. However, in March 1993, a change in banking regulations permitted existing foreign bank branches to deal in local currency on the condition that their capital be no less than $15 million, or its equivalent in foreign currency. One hundred percent foreign-owned bank subsidiaries cannot be established.

Although Banking Law 37/1992 empowers the Minister of Economy to set the rules of entry for new foreign banks into the Egyptian market, the Ministry has not yet done so.

Foreign bank branches or joint ventures operating in Egypt, including U.S. banks, are subject to CBE supervision and regulations. As of October 1994, CBE was not approving applications, of either foreign or domestic banks, to establish new branches or commence new operations. Government policy was not expected to change in the short term, as CBE officials believe Egypt is overbanked.

Foreign banks operating in Egypt, whether joint ventures or branches, can now engage in the same activities as Egyptian banks. However, public sector companies generally are required to direct their banking business to public sector banks, denying foreign-owned banks the opportunity to compete for their business. Foreign banks/branches do not face any constraints in their funding activities and have access to the Central Bank discount window.

Both foreign and Egyptian financial institutions comment on the lack of transparency in the banking laws and complain that their comments or recommendations are usually not taken into

consideration.

Egyptian Banking System
June 1993
(LE billion*)

Type of Banks	Assets	Deposits	Loans
Commercial Banks	158.976	117.618	49.617
State-owned banks	115.442	89.188	33.570
Joint ventures and private sector banks	43.534	28.430	16.047
Investment and Foreign Bank Branches	27.772	9.258	9.981
Investment Banks	n/a	6.5	7.7
Foreign Bank Branches	n/a	2.8	2.3
Specialized Banks	11.502	2.498	7.995
Total	198.250	129.374	67.594

*The exchange rate at the end of June 1993 was 1$ = LE 3.35

EGYPT

SECURITIES

SUMMARY

Prior to the Nasser era, Egypt had one of the world's most active stock markets. The statist economic policies of the Nasser Administration and the nationalization of almost all private sector companies effectively marginalized the country's securities markets. As part of Egypt's economic reform program, the government of Egypt issued Capital Market Law 95 in 1992 in an effort to reactivate the securities markets.

Under the new legal framework, foreign securities companies are provided free access to the Egyptian securities market and allowed to participate in the same range of securities activities as domestic firms. However, with the exception of two brokerage firms with American association, foreign securities firms are not active in the Egyptian market. Reluctance to enter stems from the current recession, lag in the privatization process, and the generally underdeveloped state of the market. Bureaucratic red tape in establishment procedures is another discouraging factor.

Egypt has stock exchanges in Cairo and Alexandria, which have recently been computerized and interconnected. The primary stock and bond markets are very small compared to the size of the economy. Most investors prefer establishing closed companies and resort to bank loans to finance their projects. Nonetheless, in 1993, the first two major public share offerings since 1958 were made, totalling LE 445 million ($132.8 million).

DESCRIPTION OF THE MARKET

The Legal Framework

The Egyptian securities market was very active before the 1952 revolution, when the Cairo Stock Exchange the fifth largest in the world in terms of volume traded. However, with the nationalization of private sector companies in the 1960s the securities market was marginalized. In 1992, as part of its structural reform program, the GOE issued a new Capital Market Law to reactivate the securities market. This law exempted income of publicly offered stocks and bonds from taxes, in the process providing tax treatment for securities-related income similar to that for earnings on bank deposits and Treasury bills; and it removed a ceiling of 7 percent interest on bonds. Law 95/1992 also allows, with the approval of the Capital Market Authority (CMA), the establishment of private exchanges and the establishment of Egyptian and foreign securities companies conducting one or more of these activities:

- underwriting of subscriptions;
- participation in the establishment of companies issuing securities;
- venture capital;

- clearing and settling of securities dealings;
- forming and managing securities portfolios and mutual funds;
- acting as brokerage firms.

Domestic banks as well as foreign bank branches are allowed to establish securities affiliates to conduct any of the above mentioned activities. Also under Law 95, foreign securities can be listed and traded on the stock exchange. Foreign securities, however, do not benefit from the income tax and stamp tax exemptions on dividends accorded shares of publicly held local companies. The Capital Market Law grants the CMA, a government body, considerable discretionary power concerning approvals of securities companies, issuance of securities and regulations for trading.

The Stock Exchanges

Egypt has stock exchanges in Cairo and Alexandria. Recently, the two exchanges were computerized and connected to one another. According to Law 95/1992, and its executive regulations, the Cairo and Alexandria stock exchanges operate as autonomous bodies supervised by the CMA. A Presidential Decree, not yet issued, will reorganize their administrative and financial structures. The new Capital Market Law 95 allows the establishment of private exchanges, subject to approval by the CMA, with a minimum capital of LE 10 million ($3 million). By virtue of their securities licenses, brokerage firms can be represented on the floors of exchanges by an unlimited number of representatives without having to buy an exchange seat.

Securities Companies

Under Law 95/1992, seven new brokerage firms were licensed to operate, two of which have American ties. A number of additional brokerages are in the final stage of approval. Individual brokers who were active before the issuance of Law 95 are in the process of converting to firms in compliance with the law. Furthermore, since the issuance of the Executive Regulations of the Law in April 1993, two underwriting companies, two mutual funds affiliated with the National Bank of Egypt and Bank Misr, one venture capital firm, and three holding companies were incorporated to operate in the securities market. The total capital of the licensed securities companies, excluding the two mutual funds, is LE 150 million ($44.4 million).

Although foreign investors are permitted to establish securities companies in Egypt, none of the established financial firms mentioned above, with the exception of the two brokerage firms with American association, have foreign participation. However, a joint venture commercial bank, with American participation, is in the process of applying for the licensing of a mutual fund. Foreign securities companies and foreign banks have not yet begun operations in the Egyptian securities market due to the current recession, concerns about the slow pace of privatization, and the lack of available investments. Bureaucratic red tape involved in the establishment procedures

is another discouraging factor.

Equity Market

Relative to Egypt's GDP (approximately LE 145 billion, or $42.9 billion), the primary stock market is very thin. Most investors prefer establishing closed companies and resort to bank loans. In 1993, few companies increased their capital through new issuance. The market witnessed the first two major public share offerings (Misr Chemicals Company and Commercial International Bank) totalling LE 445 million ($132.8 million) since 1958. These offerings were oversubscribed.

Stock trading in the secondary market is also limited. The Cairo and Alexandria stock exchanges have 674 companies listed, of which less than 30 percent are publicly held and the remaining are closed companies. Around 50 companies (7 percent of listed companies) are actively traded. Under Law 95, closed companies will be removed from the official lists of both exchanges by April 1994; therefore, they will not benefit from the income tax exemptions on dividends. During the fiscal year ending June 30, 1993, LE shares traded on both the Cairo and Alexandria stock exchanges totalled LE 347.5 million ($103.7 million), a 47.8 percent increase over the previous year. U.S. dollar-denominated shares totalled $70.9 million, a 10.9 percent decline over FY 1991/1992. Though figures are not available for the period July 1993 to March 1994, indicators show that the secondary stock market is picking up. Transactions are settled, at most, in three days. The slow pick-up of the secondary market is mainly tied to the lag in the privatization process. A number of public sector companies have announced their intention to make share offerings in the second half of 1994 to meet privatization targets.

Bond Market

The Egyptian bond market is insignificant. Government bonds (namely US dollar development bonds, national development bonds with variable return, and housing bonds) issued during FY 1992/1993 totalled LE 2.35 billion ($701 million), a 2.4 percent increase over the previous year. In FY 1992/1993, trading in LE and U.S. dollar bonds, in both the Cairo and Alexandria Exchanges were LE 756,000 ($225,671) and $8.5 million, respectively. However, private sector companies are starting to realize the importance of bonds as a less expensive method of financing. In March 1994, the CMA approved the issuance of private bonds, worth LE 30 million ($8.87 million) by Hoechst/Oriental, a pharmaceutical company. Currently the CMA is studying other requests for private sector bond issuance.

New Financial Products

Financial products and maturity structures are not addressed in the Capital Market Law or any other regulation. The CMA will not allow options, futures, or forward dealings. The Central Bank of Egypt, however, allowed banks to engage in forward currency dealings. Introduction

of different forms of shares or bonds with floating rates into the Egyptian market are allowed, but must be approved. As noted above, private bond issues also must be approved.

Fund Management

The Capital Market Law allows foreign banks and securities companies to establish and manage mutual funds and to sell foreign mutual funds. Founder and management companies of Egyptian mutual funds must be two separate entities. Foreign companies operating as fund managers are exempt from the minimum capital requirement. However, foreign companies are not allowed to manage pension funds because investments of these funds are regulated by the Social Insurance and Pension Laws and not the Capital Market Law.

U.S. PRESENCE IN THE MARKET

Foreign presence of U.S. security companies is very limited. No 100-percent foreign-owned security companies are operating in Egypt at this time, although two brokerage firms with American association are active in the Egyptian market. A joint venture Egyptian/American bank has obtained permission to establish a mutual fund, while an American bank branch has been asked to manage one of the two licensed mutual funds.

TREATMENT OF U.S.FINANCIAL INSTITUTIONS

In theory, Law 95/1992, and its executive regulations, provides 100-percent foreign-owned securities companies and foreign bank branches free access to the Egyptian securities market. Foreign branches and subsidiaries of foreign firms are allowed the same range of activities as domestic securities firms: underwriting of subscriptions, participation in the establishment of companies issuing securities, venture capital, clearing and settling of securities dealings, forming and managing securities portfolios and mutual funds, and acting as brokerage firms. All new products are subject to government approval.

The law favors foreign companies acting as mutual fund management companies over national companies by exempting foreign companies from the capital requirement imposed on national companies. However, because of the lack of U.S. foreign financial institutions in the market, these provisions of the law have not been tested. According to the law, foreign securities can be traded on the Egyptian stock exchanges, but they do not benefit from the income tax exemption on dividends accorded publicly held Egyptian securities. Moreover, foreign companies are not allowed to manage pension funds.

The government of Egypt does not encourage trading in foreign securities because this type of trading is considered a means for capital flight. Legally, however, residents in Egypt can access

offshore financial instruments with no limitation on either the kind or the amount of products they may invest in. There is no Egyptian legislation that would prevent Egyptian companies from listing their shares on foreign stock exchanges, provided the Egyptian company qualifies to be listed. Egyptian companies have not accessed offshore markets as issuers of securities to date. The new Foreign Exchange Law 38/1994 allowed individuals and companies free transfer of foreign currency out of Egypt.

The government of Egypt's policy is to attract foreign investments into Egypt; hence, there are no limitations on direct foreign investment in either local equity or debt instruments. The main limitation on foreign share holdings in domestic companies established under the Companies Law 159/81 is that Egyptian capital at inception should be no less than 49 percent of total capital. In addition, foreign investors are not allowed to be shareholders in inland insurance companies, export/import companies, or maritime agencies.

Foreign firms are not allowed to manage pension funds.

Foreign and Egyptian financial institutions complain of a lack of transparency of regulations. Their comments on changes in rules are usually not taken into consideration.

Exchange Rates

End of June 1993:	US$1 = LE 3.35
Current:	US$1 = LE 3.38

SOUTH AFRICA

BANKING

SUMMARY

During a time of dramatic political, social and economic transition in South Africa, the banking sector is being called upon to make fundamental changes in its own operations in order to cope with a drastic change in its operating environment. While the South African banking sector strives to emulate international trends, it has been isolated for a number of years due to economic and political sanctions. The sector will face the challenge of addressing the needs of the so-called "unbanked" — the majority of the black population who have not had access to formal financial services. As a step toward providing more financial services to disadvantaged groups, the Mutual Banks Act was implemented on January 3, 1994. This act aims to strengthen the capabilities of the informal financial sector and increase its ties to the formal financial system.

South Africa's banking sector at the end of 1993 consisted of 40 banks, of which 33 were South African-owned and 7 were foreign-controlled. Four South African banks dominate the market with approximately 80 percent of total bank assets.

South African banks are regulated by the Bank Supervision Department of the South African Reserve Bank, under guidance from the Policy Board for Financial Services and Regulation, which was established in 1993.

Thirty-three foreign banks have approved local representative offices. However, there are no U.S. banks currently operating in South Africa, although two banks are considering a presence. Foreign banks may establish a presence in South Africa via a representative office, a fully capitalized subsidiary, or by purchasing an interest in a local deposit taking institution. Branch offices are allowed only if the foreign bank has a locally registered subsidiary. Locally registered foreign banks do not face funding constraints and have equal access to the Reserve Bank discount window. The dual exchange rate mechanism makes it uneconomical to convert rand assets to foreign currencies, inhibiting both domestic and foreign banks from trading in foreign exchange.

DESCRIPTION OF THE MARKET

During the period 1990 to 1993, South African financial services legislation changed dramatically. South Africa began deregulation of the banking industry when it implemented the Deposit-Taking Institutions Act in early 1991, allowing banks to compete in previously prohibited mortgage markets. The home loan market has since become the center of the most vigorous competition in the banking industry, in part due to lower capital requirements on mortgage lending compared to other types of bank lending.

Depressed economic conditions in the early 1990s contributed to further changes in bank regulation. In 1993, legislation re-defined "deposit taking institutions" as "banks," clarified bank activities, and established a Policy Board for Financial Services and Regulation. The board, which is composed of public and private sector financial and business officials, is intended to implement a holistic approach to the regulation of financial services and to promote better coordination between the various financial regulators.

As a step toward providing better access to financial services for disadvantaged groups, the Mutual Banks Act was implemented on January 3, 1994. The act aims to improve the quality of the informal financial sector by bringing it into the banking supervision system.

Structure of the Banking Market

South Africa's banking sector at the end of 1993 consisted of 40 banks, of which 33 were South African-owned and 7 were foreign-controlled. Four South African banks dominate the market with approximately 80 percent of total bank assets. At the end of 1993, there were 34 banks with final registration in South Africa. In addition, there were 6 provisionally registered banks. Thirty-three foreign banks have approved local representative offices. However, there are no U.S. banks currently operating in South Africa, although two banks are considering a presence. The remainder of the banking system is comprised of the "mutual banks," a term defined by the 1993 law. Mutual banks include what were formerly the mutual building societies, which provided mortgages, and the various forms of credit entities that operated entirely in the informal sector prior to the 1993 legislation, such as credit unions, savings and credit cooperatives, and stokvels (informal credit unions primarily serving the black community).

Four South African banks (ABSA Bank Ltd., Standard Bank of South Africa Ltd., First National Bank of Southern Africa Ltd. and Nedcor Bank Ltd.) dominate the South African banking industry. Between them they control approximately 80 percent of total assets. Because of the dominance of the "Big Four" banks, the discussion that follows largely reflects their positions.

Electronic clearing takes place in South Africa through the Bankserve System. The automated teller machines (ATM) that operate within the system are governed and regulated by Saswitch. Saswitch in turn, is an organization composed of the "Big Four" South African banks. There is no public sector regulation of ATMs as they are the private property of the banks.

The banks' balance sheet shows that 77 percent of the banks' total funding is deposits from banks and nonbanks, and the main use of funds, accounting for 83 percent of the total, is loans and advances to banks and nonbanks. Recent growth in total assets was funded mainly from increased deposits from nonbanks of 17 billion rand (9.3 percent), and significant expansion in other liabilities of 6.1 billion rand (51.5 percent), and capital and reserves of 4 billion rand (27 percent).

Balance Sheet for the South African Banking Sector, 1993
(millions of rand)

Liabilities	
Total Deposits — Nonbanks	200,036
Interbank Funding	28,340
Foreign Funding	12,353
Loans Received Under	
Purchase Agreements	8,584
Other Liabilities	18,036
Acceptances Rediscounted	8,514
Capital and Reserves	18,835
Total	294,698
Assets	
Loans and Advances — Nonbanks	233,246
Interbank Advances	12,472
Investments	20,100
Fixed Assets	7,539
Acceptances Discounted	8,515
Other Assets	7,958
Monetary Assets	4,868
Total	294,698

Exchange Rate for 1993: 1$ = 3.2667 Commercial Rand

Loans and advances constitute the major areas of credit-risk exposure. In 1993, loans and advances to the public represented 79 percent (233.3 billion rand) of total assets, up from 78 percent (209.9 billion rand) in 1992. The growth in loans and advances (11.1 percent) was caused mainly by growth in mortgage loans totalling 14.3 billion rand.

Overdues related to mortgage loans increased 34.2 percent during 1993. The effect of banks increased exposure in this area is manifested in the composition of arrears. In June 1992, three months after mortgage lending exceeded traditional loans and overdrafts for the first time, overdues on mortgages also exceeded arrears on installment loans for the first time. The increase in mortgage loans in bank portfolios was accompanied by a decrease in the banks' long-term funding, indicating increased liquidity risk. Specific provisions were made for 53.5 percent of the total loans overdue.

Bank Regulation

In September 1992, the Committee of Investigation into the Promotion of Equal Competition for Funds in Financial Markets in South Africa (the Jacobs Committee) recommended implementation of a holistic approach to the regulation of financial services in South Africa. On November 15, 1993, the Policy Board for Financial Services and Regulation began operations as a statutory body under the terms of the Policy Board for Financial Services and Regulation Act of 1993. The Policy Board, while able to appoint advisory committees and boards for the different categories of financial institutions and services, will not serve to integrate existing regulatory offices into a single structure.

South African banks are regulated by the Bank Supervision Department of the South African Reserve Bank, under the guidance of the Policy Board.

The Council of Southern African Bankers, established in March 1992, provides the banks with a common voice with which to address matters affecting the industry in a coordinated manner. CoSAB is a private sector organization whose main aim is to promote the interest of the banking industry.

The Policy Board, the Reserve Bank, and the Council are focusing on creating an environment that will facilitate the improvement of the quality and effectiveness of financial risk management in the banking system. Three concepts underlie their approach — accountability, risk management, and transparency. The Bank Supervision Department of the South African Reserve Bank has created a nine-section risk management model for assessing bank risk. In addition, new regulations, published in the South African Government Gazette of December 28, 1993, simplified risk management statutory reports and subordinated them to the reports submitted by bank's management to its board.

South African bank regulators are implementing the guidelines of the Bank for International Settlements regarding capital adequacy for banks, except for foreign exchange and interest related contingencies. Capital requirements for foreign exchange and interest rate exposures will be applied at some future date to ensure that South Africa complies with international standards. South African banks are required to maintain a capital-to-risk-weighted asset ratio of 7 percent as of January 1, 1994. The fully phased-in ratio of 8 percent will take effect on January 1, 1995.

The concept of a deposit insurance system is currently under discussion. The South African Reserve Bank is considering options for implementing a system of privately funded deposit insurance.

The Mutual Banks Act of 1993 was implemented on January 3, 1994. The category of "mutual banks" was established to encompass the mutual building societies and the various forms of

financial organizations that had been operating in the informal sector. Mutual banks will be subject to the same standards of accountability as banks. The organizations that had been informal must now register as mutual banks, but will be self-regulating.

U.S. PRESENCE IN THE MARKET

Thirty-three foreign banks have approved local representative offices. There are currently no U.S. banks operating in South Africa. However, there are two U.S. institutions that are, reportedly, contemplating a presence in South Africa.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks may establish a presence in South Africa via a representative office, a fully capitalized subsidiary, or by purchasing an interest in a local deposit taking institution. Branch offices are allowed only if the foreign bank has a locally registered subsidiary. Locally registered foreign banks do not face funding constraints and have equal access to the Reserve Bank discount window. Under the dual exchange rate mechanism, the rates at which foreign currencies can be converted to rand are more favorable than the rates at which rand can be converted to foreign currencies. This inhibits both domestic and foreign banks from trading in foreign exchange.

SOUTH AFRICA

SECURITIES

SUMMARY

For South Africa, the end of a drought and a higher gold price in mid-1993 coincided with the lifting of international sanctions and a return to economic growth in 1993 after four years of recession. These positive developments were reflected in increased activity in the South African securities sector, and generated considerable interest among foreign investors towards the end of 1993.

The Johannesburg Stock Exchange (JSE) is the only stock exchange in South Africa and by capitalization ranks among the world's 15 largest. While capitalization has greatly increased in recent years, trading volume, despite some recent gains, remains very low. By contrast, a futures market, operated by the South African Futures Exchange, features a substantial level of trading.
The JSE has a dual capacity, operating an equities market and a traded options market. Pending the full licensing of a new and separate bond market, the JSE continues to operate a market floor for trading "gilt" (bonds).

Although the Policy Board for Financial Services and Regulation is responsible for the coordination of overall regulatory policy affecting the financial markets, the JSE is a self-regulatory organization subject to the provisions of the National Stock Exchange Control Act of 1985.

Foreign exchange control regulations precluding outward investment by domestic corporations and individuals are currently in force in South Africa. A dual currency system facilitates inward investment, however. Foreign transactions in the securities sector are settled in the investment currency for non-residents, the financial rand. The all-purpose currency for South African residents is called the commercial rand. The financial rand is quoted in U.S. dollars and trades freely between foreign investors, at a discount to the commercial rand, thereby facilitating foreign investor activity in South African securities markets and improving yields.

No U.S. securities firm has a formal presence in South Africa, as South African citizenship is a prerequisite for membership on the JSE. Nevertheless, U.S. firms are active in underwriting South African issues in international markets.

DESCRIPTION OF THE MARKET

Regulation

The Policy Board for Financial Services and Regulation is responsible for the coordination of overall regulatory policy affecting the financial markets. The executive officer of the Financial

Services Board serves as a representative of the government to oversee the securities market. The board oversees sub-groups that have responsibility for dealing with specific financial market sectors.

The JSE is a juristic person capable of suing and being sued in its own name and is duly licensed to carry on the business of a stock exchange in accordance with the terms of the Stock Exchange Control Act of 1985, which provides the necessary regulatory framework. A JSE committee draws up self-regulatory rules and directives. The activities of the committee and members of the JSE are, in addition, governed by the rules promulgated in a section of the Stock Exchanges Control Act.

Where brokers trade in other financial markets (e.g., options or futures) their activities are regulated by the legislation governing those markets. Such regulation primarily falls under the Financial Markets Control Act of 1989. The Banks Act of 1990, and its regulations are relevant in the context of money market operations. The regulations of the South African Reserve Bank govern the activities of brokers and their overseas clients in financial rand transactions.

There are no impediments to the introduction of new financial products as long as they are consistent with the existing regulatory regime.

Dual Currency and Foreign Exchange Controls

Authorities maintain a dual currency, which is an important aspect of South African financial markets, particularly for nonresident investors. Use of the financial rand facilitates nonresident access to the South African securities market, and trades at a discount to the commercial rand, the latter being the all-purpose currency for South African residents. All capital transactions use the financial rand, whereas all interest is paid in commercial rand.

Foreign exchange controls were first introduced in the 1960s to inhibit the repatriation of capital by foreign investors in order to conserve foreign exchange reserves. The measures restrict the outflow of foreign capital by requiring financial rand holders to find another foreign investor to buy their financial rand in order for the original holder to exchange financial rand for foreign currency.

With regard to the sequence of necessary transactions, the sale of securities listed on the market and held by foreign investors will give rise to the creation of a financial rand balance. The financial rand can be sold to another foreign investor who pays the seller in foreign currency, with the seller transferring his or her rand balance to the buyer. Thus, while foreign investors are restricted to selling their financial rand only to other foreigners, they can remit dividends and interest income overseas via the commercial rand.

Use of the dual currency allows foreign investors, in effect, to buy securities at a discount from

actual market value, enabling them to obtain a superior yield.

Financial rand balances are lodged with an authorized dealer even when under the control of a broker, and settlement of securities purchased and sold may take place only through these accounts. The South African Reserve Bank appoints certain branches of banks as authorized dealers.

Domestic and international pressure is growing for the government to dismantle South Africa's exchange controls. Two conditions are widely acknowledged as prerequisites to unification of the dual system, however. First, the discount rate between the commercial and financial rand would have to be reduced (as of June 1994 it was approximately 25 percent, 11 percentage points higher than in 1983). Second, the country's supply of foreign exchange reserves would have to rise to a more comfortable level (import cover as of June 1994 stood at roughly six weeks). Presently, there is concern that unification of the commercial and financial rands would undo much of the progress that has been made in reducing inflation in South Africa. In addition, the dual exchange rate system continues to offer certain advantages, including incentives for foreign investment and reduction of short-term interest rates (due to foreign purchases of local bonds).

Bond Market

South Africa offers a wide variety of bonds with an array of coupons and maturities. The largest, most active issuers include the South African Government (Republic of South Africa bonds), the Electricity Supply Commission (Eskom), and the Posts and Telecommunications (SAPO). Foreign investors are also very active in the South African bond market.

The South African bond market has been comprised of a regulated open outcry floor markets at the JSE and an OIC screen quotation/telephone execution dealer driven system that was not regulated. These two markets are presently being merged into the Bond Market Association.

The JSE continues to operate a market floor for trading bonds during the phase-in period. In 1993, "gilt" (bond) turnover reached a peak of 803.1 billion rand, exceeding the previous year's record of 621.1 billion rand. The number of deals concluded rose from 223,192 to 261,946.

In June 1990, a ratings agency (Republic Rating) was established to provide reliable information and risk assessments on South African financial markets for investors.

Equity market

Events in commodities markets and the domestic political area have traditionally driven South Africa's stock market. In 1993, despite still-weak economic activity, high real interest rates, low commodity prices and a weak corporate profit outlook, the JSE rallied on the strength of

index performance. The Industrial Index and Overall Index reached record highs by end-1993, the latter rising by 50 percent. The value of shares traded on the JSE doubled last year, and although the number of listed companies fell to 647, total market capitalization reached R737 billion by year-end. Natural resource-related stocks account for 40 percent of total market capitalization.

In spite of the buoyancy of the market — the increased market capitalization and improved trade volumes — the 9.8 billion rand raised in new issues during the year was 15.5 percent less the 11.6 billion raised in the previous year. Most of the new capital raised in both years was through rights issues. Now that an economic recovery has started, it is expected that there will be an increase in new listings.

While trading volume was up (turnover was 127 million shares in 1993), this measure of stock market activity remains relatively low. Factors underlying this trend include the dominance of the shares of a relatively few large local institutions and the generally poor liquidity of the market occasioned primarily by exchange control regulations and the concentration of investing power.

In 1992, a committee of JSE members was formed to discuss future deregulation of the stock market in South Africa's evolving political (as well as economic and business) climate. Recommendations released earlier this year included: removal of South African citizenship as a qualification for membership, suspension of dual capacity in the equities market (until exchange control related-illiquidity in the JSE is alleviated), revision of brokers' capital requirements, and development of an electronic registry.

Options Market

Options are traded on the JSE as well. However, while the market infrastructure is in place, it remains inactive. The future of the traded options market will be reevaluated after the admission of a new class of corporate member to be known as a derivative member.

The Stock Exchanges Control Act was amended by Parliament in 1993 to permit admission of this new class of member. Derivative members, which will have limited rights to trade, will be admitted to the JSE in 1994. The rights of these members are being developed; the primary aim is to permit creators of derivatives to hedge their positions by having direct access to the cash market.

Futures Market

A futures market is operated by the South African Futures Exchange (SAFEX). Trading amounted to R105 billion in 1993, then accelerated markedly during 1994, reaching R121 billion by July. Trading volatility in the SAFEX, which is a derivatives market, was caused primarily by questions regarding the political environment in the run-up to the April 1994 elections.

U.S. PRESENCE IN THE MARKET

Current legislation prohibits foreign nationals, individuals or firms, from undertaking securities market activities either directly or by establishing a locally incorporated subsidiary. The JSE has made recommendations for this prohibition to be removed, which will necessitate a change in the Stock Exchange Act. It is also recommended that the act be changed to permit brokers to sell up to 30 percent of limited liability stockbroking companies to nonbrokers.

Several foreign securities firms have "listening posts" or "nameplate" offices in South Africa. These are not registered, have no legal status, and can conduct no business directly in the markets.

Several U.S. firms are active in providing underwriting services to South African residents issuing securities offshore, an activity that has grown recently. Given the prohibition on foreigners operating in the South African market, such activity is apparently initiated by South African issuers seeking out U.S. and other foreign service providers in overseas markets.

Foreign investment in South African equity and debt instruments is not subject to foreign exchange regulation. U.S. investors, both individual and institutional, are very active.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

As noted, there is a legal prohibition against foreigners operating in the South African securities market.

Exchange Rates

Average 1993:	US$1 = 3.267 Rand
End of year 1993:	US$1 = 3.401 Rand

EUROPEAN UNION

INTRODUCTION

This part of the National Treatment Study, "European Economic Area," contains seven chapters, including this one on the European Union (EU). The chapters on Belgium and Italy deal with securities only, whereas the chapters on Greece, Portugal, and Spain cover both the banking and securities markets in those countries. The seventh chapter covers market conditions in nine additional EU and EFTA countries. The focus in these abbreviated reports is on the implementation of the EU Financial Services Directives throughout the European Economic Area.

This chapter describes the program of the European Union (formerly the European Community)[1] to create a "single market" for financial services among its member states, and problems that might arise for U.S. financial institutions as a result of that process. The chapter begins with a general overview, including implications of the single market process for the operations of United States' banks and securities firms in the area. In separate sections on banking and securities, key "single market" legislation is described with assessments of the effects on U.S. firms. Another section briefly describes bilateral discussions between the United States and the European Commission on financial services issues. The final section of the chapter provides a synopsis of conditions in the markets of most states in the European Economic Area.

Single Market

Elimination of internal barriers to trade in goods and services, including financial services, has been a primary goal of European policy since the founding of the European Economic Community by the Treaty of Rome in 1957. The Cecchini Report contributed to a re-invigoration of the process in the mid-1980s by underscoring that the continued existence of barriers weighed heavily on the European economy. The report pointed out that the removal of remaining restrictions in the financial services sector alone would, it was expected, add some 1.5 percentage points to EU Gross Domestic Product, about one-fourth of the total gains attributable to the entire single market program. Shortly thereafter, in 1987, the Single European Act entered into force, under which some 300 directives, 10 percent of which were in the financial sector, were to be implemented to realize the creation of a single market.

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[1]The countries comprising the European Union are: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom. Austria, Finland, Norway and Sweden have signed accession agreements, which, if ratified, should bring them into the EU on January 1, 1995. On January 1, 1994, the "European Economic Area (EEA)" agreement took effect between the EC and EFTA (except Switzerland).

One reason elimination of barriers in the financial services area was expected to contribute so significantly to economic growth was that the European financial industry was highly fragmented. Each member state had its own traditions for regulating banks, insurance companies, and investment firms. Controls on trade, capital, and exchange impeded cross-border provision of financial services and branching. These differing traditions made adoption of a unified approach to prudential supervision and regulation virtually impossible, and early attempts at such "harmonization" had to be abandoned.

The EU's approach to creating a single market in financial services, whether in banking, securities, or insurance, is based on three elements: establishment of minimum essential levels of prudential regulation and supervision acceptable to all member states; mutual recognition of licenses for a defined list of covered services; and home country supervision. A member state may impose more stringent prudential requirements on firms that it licenses, and it may limit the number of covered services in which they may engage.

Once the relevant single market legislation is fully in force, a bank, insurance company, or securities firm licensed in one EU country may provide any of the covered services for which it is licensed in the territory of any other member state, either through branches or cross-border sales. The home country regulator that licensed the institution and determines the range of its permissible activities supervises its activities throughout the EU. In theory, this approach can result in EU firms' receiving *better than national treatment*: an institution permitted to engage in a covered service in its home country may offer it in another even if the host country regulator does not permit local institutions to do so. The home country regulators must notify those in the target country of an institution's activities, but no additional authorization is required. Host country regulators retain residual rights to establish "conduct of business" rules (for example, on advertising); to adopt measures for "the general good;" and to impose measures necessary for the implementation of monetary policy.

As will be discussed in more detail below, the EU has now adopted all of the directives needed to create the "single market" in banking, insurance, and investment services.[2] The single passports are included in the "framework" directives: the Second Banking Directive, the Third Life and Non-life Insurance Directives, and the Investment Services Directive. The single market in banking entered into force on January 1, 1993, and that for insurance on July 1, 1994. The single market in securities will take effect on January 1, 1996. Member states must transpose the requirements of the directives into national law before the effective date of the single market. It should be noted, however, that union law has legal effect even if a member state has not transposed the directives into national law. Accordingly, institutions from other member states may still exercise their "single passport" rights in that state.

[2]This report covers in detail the single market in banking and securities only.

Despite the adoption of the key framework directives, other factors inhibit the creation of a true single market. Capital controls have been abolished by all member states, but regulations affecting the investment decisions of pension funds and other institutional investors impose indirect but significant restrictions on capital flows. Similarly, differences in tax systems also restrict full integration of financial markets, as do rules and regulations governing company law, corporate governance, and the structure of financial markets.

The November 1993 entry into force of the new Treaty on European Union (the Treaty of Rome as amended by the Maastricht Treaty) adds three new factors to the single market process. The new treaty stipulates that economic and monetary union should come into force no later than 1999. By establishing a common currency for the EU, monetary union will "complete" the single market in financial services. Second, for the first time, EU law regulates capital movements with third countries, rather than just among the member states. This may lead to the extension of EU competence and legislation over member state treatment of third country investment, including over "direct" third country branches. Such branches are now outside the scope of the framework financial service directives and do not benefit from the single passport. Instead, they are subject to host country laws and regulations. Finally, the treaty strengthens the European Parliament's role in single market legislation by compelling "conciliation" in the event that the Council does not accept the Parliament's proposed amendments, and by granting the Parliament for the first time a right to veto legislation. This veto right could slow down passage of future financial services legislation.

European Economic Area

The European Economic Area (EEA) agreement entered into force on January 1, 1994. Originally scheduled to come into effect on January 1, 1993, the Swiss rejection of EEA membership in December 1992 meant that the agreement had to be adjusted and re-ratified by the remaining participants, a process that was completed in December 1993. The final EEA treaty applies to the 12 EU member countries, plus Austria, Finland, Iceland, Norway, and Sweden. Liechtenstein is scheduled to join the EEA after completion of bilateral negotiations amending its customs union with Switzerland.

Free movement of services, the EEA's second basic principle, is generally seen as the EEA's most innovative contribution. Basically, the EEA provides that Austria, Finland, Iceland, Norway, and Sweden will adopt the EU's single passport approach to banking, insurance, and investment services. This means that, as of January 1, 1994, a Swedish bank is in principle allowed to do business throughout the EU from its Stockholm base, with EU banks having the reciprocal right to seek clients in EFTA countries without having to set up fully incorporated subsidiaries there.

The EEA agreement lays down specific provisions covering relations with third country credit institution/insurance undertakings. An authorization granted in the EU or in an EFTA state to

a third country financial institution/insurance company will normally be valid throughout the whole EEA. There are, however, two exceptions to this rule:

- When a third country imposes restrictions on the establishment or operations of an institution of an EFTA state, which are not imposed on EU institutions, authorizations granted by the EU to institutions of that country shall be valid in the EU only, except if the EFTA state in question decides otherwise; and

- Where the EU has decided that authorizations for a third country institution shall be limited or suspended, authorizations granted by a competent authority of an EFTA state to such institutions shall be valid only in its jurisdiction, except when another contracting party decides otherwise.

These exceptions do not apply to credit institutions/insurance undertakings already authorized in EEA territory.

General Implications for U.S. Financial Services Firms

Implementation of the single market is not complete and its full effects are yet to be realized. However, certain issues have arisen and some nascent trends may be discernible. From the perspective of non-EEA members, a crucial distinction is made between the treatment of firms incorporated in the area and those that enter as branches. In general, the former are subject to the provisions of the single market directives, but the latter are not. This means that firms wishing to enter as subsidiaries are subject to a uniform reciprocity test (except as modified by EFTA countries as described above). Once established, these firms receive all of the advantages of the single passport.

However, establishment and permissible activities of direct branches is subject to the authorization of individual countries and these procedures may employ criteria ranging from "unconditional" national treatment, to "reciprocal" national treatment" or "mirror image" reciprocity. At least one EU country (France) appears to have language in its legislation that could impose a mirror image reciprocity test in the authorization of non-EU branches. After establishment, third country branches may be subject to national rules that are more restrictive than those that can be applied to holders of the single license (e.g., capital standards).

The only EU-wide stipulation is that foreign firms may not be afforded better treatment than EU firms. In these circumstances, non-EEA branches may not be provided the full powers of the single license in every market. (Under the Maastricht Treaty, a common policy may be adopted toward third country branches; however, this would be unlikely to occur before 1999.)

Regarding firms incorporated in the EU, the single market directives embody the concept of "home country" supervision. Nevertheless, substantial residual scope for "host country"

supervision is retained, especially concerning "conduct of business" rules, consumer protection, and "general good" clauses. This opens the possibility that financial services providers will continue to need to adapt to diverse rules in different jurisdictions. Although not necessarily a national treatment issue, U.S. firms have expressed concern that rule implementation at the national level could result in discrimination. However, the European Court of Justice has ruled that such measures must be applied in a nondiscriminatory manner.

In addition, instances have been cited of EU member states prohibiting or discouraging the provision of activities subject to mutual recognition through branches or cross-border. One member state (France) has made clear its preference that if services are provided to its residents on a regular basis, these services be offered from within its borders and not on a cross-border basis. This is more an intra-EU issue than one of national treatment. However, U.S. firms incorporated in the EU have a strong interest in seeing the established rules applied.

Lack of transparency in regulation can exacerbate potential problems. At the EU level, deliberations by the Commission and the Council on proposals are never open to the public and the working documents are restricted. This is justified on the grounds that such deliberations are in effect diplomatic negotiations between sovereign states. However, financial services directives are by nature highly technical, and U.S. firms have expressed concern that failure to involve adequately the public in their preparation can result in provisions that are less than optimal.

Transparency in the development and implementation of rules at the national level is of equal, if not greater concern. The EU does not have responsibility for transparency at the national level, although it is responsible for ensuring that member state regulation and practices are consistent with EU law. Experience to date indicates that policies followed at the national level can vary widely. Transparency in regulatory procedures is in need of improvement at both the EU and the national level.

THE BANKING SECTOR

Summary

The single market in banking services began on January 1, 1993, with the entry into force of the Second Banking, Own Funds and Consolidated Supervision Directives. (The Solvency Ratio Directive had previously come into force.) The Large Exposures Directive became effective on January 1, 1994. A Deposit Protection Directive will be implemented on July 1, 1995. Directives strengthening supervision in the wake of the BCCI scandal and establishing common approaches to bankruptcy and conglomerates are under consideration. Member states have generally implemented directives on time.

According to EU data, total assets of EU credit institutions at the end of 1992 was ECU 8.2 billion, while the comparable figure for U.S. banks was ECU 4.2 billion. A substantial portion of U.S. banks' assets are held in the EU area. According to Federal Reserve data, at the end of 1993, U.S. banks' branch assets in the EU were about 42 percent of total assets located in foreign countries and assets of U.S. subsidiaries in the EU accounted for about 54 percent of that total.

Subsidiaries of U.S. banks established in an EU member state receive national treatment under the EU banking directives, and may take full advantage of the single market. Direct branches of U.S. banks, however, are not covered by the Second Banking Directive and so are not eligible for the "single passport." As a result, a U.S. bank cannot undertake EU-wide operations supported by the parent bank's capital unless the bank establishes direct branches in each member state. Most individual country authorizations to establish and operate are subject to a reciprocity test. After establishment, branches may encounter different rules with respect to capital and other requirements. However, member states may conclude bilateral agreements with third countries for the mutual recognition of branches. Such an agreement has been concluded between U.S. and German banking supervisory authorities.

The Second Banking Directive includes a "reciprocal national treatment" provision under which the EU may deny issuance of a license under the directive to a bank owned by an institution in a country that does not provide national treatment to EU banks. Institutions established as of January 1, 1993, are explicitly grandfathered. The EU believes that European banks in the United States generally receive national treatment. It has, however, expressed concern that the possible imposition of Federal Reserve bank examination fees on foreign institutions could represent a denial of national treatment. In addition, the EU complains that the separation of commercial and investment banking and insurance in the United States and the restrictions on interstate branching and banking lessen competitive opportunities for EU universal banks in the United States relative to the opportunities that European subsidiaries of U.S. banks enjoy in the single European market. (See the chapter on National Treatment Under U.S. Laws for details on these issues.)

The Banking Industry in the European Union

Presence of U.S. Institutions

At the end of 1993, U.S. banks operated 106 branches with assets of $156 billion and 187 subsidiaries with assets of $128 billion in the 12 member states of the European Union. In general, EU branches of U.S. banks are located in major financial centers and are engaged primarily in wholesale banking activities. Branches located in London accounted for more than seventy percent of the end of 1993 asset total of branches located in the EU. The EU subsidiaries of U.S. banking organizations include banks (some of which engage in securities operations), investment firms, and finance and leasing companies. Nearly 57 percent of the total

assets of U.S. bank subsidiaries in the EU was accounted for by those firms located in the United Kingdom.

Single Market Legislation

The single market in banking services began on January 1, 1993, with the entry into force of the Second Banking, Own Funds, and Consolidated Supervision Directives. The Solvency Ratio Directive had entered into force in 1991, while the Large Exposures Directive became effective on January 1, 1994. Directives strengthening supervision in the wake of the BCCI scandal and establishing common approaches to bankruptcy and conglomerates are under consideration. A Deposit Guarantee Directive was adopted on May 30, 1994 and will enter into force on July 1, 1995.

The *Second Banking Directive* (SBD), adopted December 15, 1989, permits a bank chartered in a member state (including subsidiaries of U.S. or other foreign banks) to engage throughout the EU in any of the 14 services covered by the directive (see exhibit 1 at the end of this section) and allowed by its licensing authority. The SBD adopts the universal banking model; banks established in member states that allow universal banking may conduct securities underwriting, dealing, and distribution as well as traditional banking. Services can be provided either cross-border or through branches. The providing bank must notify its licensing authority of its intent to undertake these activities; the home country regulator in turn notifies the regulators in the target country. The authorities in the target country may not obstruct the activities even if their own domestic banks may not participate in them. Banks are regulated and supervised by the home country authority. Host country regulators may adopt measures to protect the "general good." The concept of "general good" is not well-defined; however, EU jurisprudence requires that any measure taken to protect the general good be nondiscriminatory and as limited in scope as possible to achieve the stated goal. Host country regulators also are responsible for monetary controls and for ensuring that a branch maintains adequate liquidity.

Along with SBD, the Own Funds, Solvency Ratio, and Large Exposures Directives establish the minimum essential prudential requirements for credit institutions that underlie the single passport.

The *Own Funds Directive* defines "Tier 1" and "Tier 2" capital in a manner generally consistent with Basle Committee for Banking Supervision recommendations and specifies, where appropriate, the maximum amount of each component of capital that may be included. The directive permits member states to include all or some of the components in their definition of capital and to opt for lower ceilings for the qualifying amounts.

The *Solvency Ratio Directive* relates the capital of a credit institution to its risk-adjusted assets. The directive again parallels the work of the Basle Committee, although some minor differences in the risk weightings exist. The directive requires credit institutions to maintain a minimum

solvency ratio of 8 percent; member states may impose a more stringent standard. Should the risk-adjusted capital ratio of a bank fall below 8 percent, the relevant supervisory authorities are required to ensure that corrective measures are taken.

The *Large Exposures Directive* stipulates that a bank may not allow exposure to an individual client or a group of connected clients to exceed 25 percent of capital (20 percent if the client is related to the bank) and that the aggregate of exposures of 10 percent or more of capital cannot exceed eight times the total capital base. (The directive contains numerous exceptions, especially pertaining to interbank claims and government assets, and includes lengthy transition periods during which the above percentages are respectively 40 percent, 30 percent, and 15 percent of capital.)

The *Consolidated Supervision Directive* requires compulsory consolidated supervision of all credit institutions and other financial institutions within a bank or a financial holding company structure. Capital, solvency, and large exposure standards are applied to the group even where the credit institution is a subsidiary (although not all subsidiaries are subject to the capital requirements). Where a parent credit institution has a bank subsidiary, the parent's supervisors are responsible for consolidated supervision. Authorities where the subsidiary is located may exercise local supervision or delegate this to the parent's supervisory authority. If a credit institution is the subsidiary of a financial holding company, consolidated supervision is the responsibility of the supervisors that authorized the credit institution. When a group has more than one credit institution and more than one member state is involved, the directive provides guidelines for determining which bank regulator is responsible for consolidated supervision; concurrent supervision is possible. These five directives are the heart of the single market in banking, but a number of ancillary directives also are under consideration.

One directive under consideration consists of amendments to a number of existing directives, initiated in the wake of the BCCI scandal, is intended to strengthen supervision of banks, as well as other financial institutions, by requiring greater transparency in the relations between a bank and other companies, enhancing information exchanges between supervisory authorities, requiring a bank's registered and head office to be in the same member state, and increasing the responsibility of accountants.

The *Deposit Protection Directive* will take effect on July 1, 1995. It will require each member state to have a deposit guarantee scheme; to insure deposits to at least ECU 20,000 ($22,000); to extend these guarantees to all EU branches of its domestic banks; to permit branches of other EU banks to "top up" in their local schemes if those provide better coverage than their own national schemes; and to preclude banks from countries that have more generous schemes from using these for competitive advantage by capping coverage at the host state's level. The Commission also has long advocated having a common approach to the liquidation of banks. However, major differences in member state bankruptcy law and practices have precluded this. Finally, the Commission is considering proposing a directive that would preclude double gearing

of capital and other prudential problems associated with financial conglomerates, especially those containing both banking and insurance businesses.

The Treatment of U.S. Banks Under EU Law

As noted previously, U.S. bank subsidiaries established in an EU member state receive national treatment under EU law — that is, none of the banking directives discriminate on the basis of ownership, and all banks legally established in the EU enjoy equal treatment under the directives.

Second Banking Directive

The Second Banking Directive, however, does include a reciprocity clause. The member states are meant to notify the Commission of instances in which third countries deny national treatment or effective market access to their banks. The Commission, in turn, is required to make periodic studies and report on the treatment that EU institutions receive in third countries. If the Commission determines that a country does not provide national treatment for EU banks, it may initiate negotiations with that country and may limit or suspend requests for new authorizations or acquisitions by banks from that country. These sanctions may not exceed three months unless the Council decides by qualified majority that they shall be continued. Banks already established in the EU are grandfathered and cannot be affected by these sanctions. In addition, if the Commission determines that a third country is not providing effective market access comparable to that granted by the EU to banks from that country, the Commission may initiate negotiations to improve market access. Lack of comparable market access, however, is not grounds for sanctions.

An EU report, dated July, 1992, affirmed that European banks generally receive national treatment under U.S. law, and that it is unlikely that the SBD's reciprocal national treatment clause will be applied to the detriment of U.S. banks. However, the Commission has maintained that the United States does not provide "effective market access comparable to that provided by the EU" due to the separation of investment and commercial banking and insurance and the restrictions on interstate branching. Accordingly, the EU has expressed interest in proposed reforms of U.S. banking laws that would remove these restrictions (see the chapter on National Treatment under U.S. Laws for an update on U.S. legislative developments).

In addition, in March 1994, EU Commissioner Christophersen and the Chairman of the Council of Economic and Finance Ministers wrote to Treasury Secretary Bentsen, Federal Reserve Chairman Greenspan, and key Congressional leaders expressing their concern about the possibility that the Federal Reserve would levy discriminatory bank examination fees on foreign-owned institutions in the United States. This issue could lead to the activation of the reciprocity clause, depending on how it is resolved.

Treatment of Branches

A very important feature of the treatment of U.S. banks under EU law is the exclusion of direct branches from the benefits of the single license. Direct branches from non-EU countries are subject to the 1977 First Banking Directive, which states that they may not be provided better treatment than EU institutions, and are otherwise subject to member state law. They are not subject to the Second Banking Directive because these branches have no legal personality in the EU. In addition, the parent banks of these branches are not subject to the EU's common prudential requirements. Some member states believe direct branches fall within the purview of their traditional competence over third country investment.

Some in the U.S. industry argue that the inability of their branches to benefit from the single passport puts them at a disadvantage, because their European operations cannot be supported by the parent company's capital base. This constitutes a denial of the principle of "investor choice," which permits foreign banks to choose whether they wish to establish as branches or as subsidiaries. The result is that in order to operate widely within the EU on the basis of parent capital, U.S. banks would need to file multiple applications and operate under diverse capital rules. This approach has higher administrative costs and inefficiencies. In a given market, a third country (e.g., U.S.) bank might be precluded from providing services that are authorized under the SBD, through a direct branch.

"Dotation Capital"

The issue of lending limits on U.S. bank branches based on local ("dotation"/endowment) capital provides a good illustration of how single market liberalization can paradoxically have a detrimental impact on the competitive positions of U.S. banks. It also provides an example of how bilateral cooperation can resolve such a problem.

When the Second Banking Directive entered into force on January 1, 1993, a number of EU countries, including Germany, Italy, and Spain, had long maintained "dotation" capital requirements on foreign bank branches. These include minimum capital requirements, lending limits tied to local capital, single large exposure limitations, solvency ratios, and limitations on foreign exchange positions. Although prudential considerations were the primary reason for these requirements, in practice they also served to disadvantage foreign bank branches by raising costs. Under the SBD, such capital requirements were eliminated for EU bank branches, but U.S. and other foreign bank branches remained subject to them. The result was to put U.S. banks at a competitive disadvantage to EU banks. Because U.S. banks are supervised according to international standards, there is no prudential rationale for maintaining dotation capital limits.

Those countries that have been approached by the United States have expressed a willingness to cooperate on finding a means to provide relief from the local capital requirements. In the case of Germany, an agreement to do so has been reached (see the report on Germany in the

appendix). Discussions on dotation capital are anticipated, with Spain in October 1994 and with Italy in December 1994.

Other Issues

A concern expressed by both European and U.S. banks is that the host country supervisors in some member states may use their residual authority over conduct of business rules or their right to take measures in the interest of the "general good" to limit the advantages of the single license or otherwise protect local institutions. The European Court of Justice, however, has limited the use of the general good exception. Any measure undertaken in the interest of the general good must be objectively justified, nondiscriminatory, and "proportional" — i.e., the least restrictive means of protecting the general good. No U.S. bank has cited specific instances of misuse of these provisions.

A subset of issues related to EU law come generally under the heading of consumer protection. In particular, certain provisions being considered relative to data processing and protection and "distance" selling may have a disproportionate impact on U.S. banks. However, the EU Commission says that the data protection area will be harmonized at the EU level and hence no longer subject to invocation of the general good clause. The EU Commission further states that the Distance Selling Directive does not apply to financial services.

As noted in the discussion of the Consolidated Supervision Directive, if a credit institution is a subsidiary of a financial holding company, consolidated supervision is the responsibility of the supervisor that authorized the credit institution. However, for EU financial groups, supervision on a consolidated basis is undertaken by the home country supervisor that licensed the parent. Host country supervision applies for the financial holding companies with non-EU parents. The directive's methodology for measuring capital for solvency and large risk would likely require non-EU financial holding companies to curtail significantly their operations.

The Consolidated Supervision Directive provides for possible EU agreements with third countries to broaden the application of consolidated supervision. These agreements would provide the framework for subsequent bilateral agreements or understandings between the competent authorities in the third country and their member state counterparts. Pursuant to this authority, the Commission obtained Council approval to enter into negotiations toward a framework agreement with the United States. The Commission has requested that the United States negotiate an agreement on information exchange to support consolidated supervision. This would serve as the framework for subsequent bilateral understandings between U.S. and member state competent authorities and could alleviate problems for U.S. banks that might otherwise arise due to member states' transposition of EU directives into their own national law.

EEA Liberalization

Although it is premature to make a definitive statement on the impact of the EEA on U.S. banks, the following observations can be made:

- The EEA has potentially increased the number of countries with reciprocity provisions, since Sweden had none previously. However, Swedish authorities have stated that the treatment of third country applications remains unchanged.

- There is no guarantee that a bank receiving authorization to establish a subsidiary in an EU or EEA-EFTA country will be able to operate throughout the entire EEA.

- Procedures concerning branch applications remain unchanged. Apparently, a reciprocity test is imposed by all members except Sweden.

In these circumstances, EEA-EFTA liberalization that is extended to branches of EU banks and not to U.S. branches will put the latter at a competitive disadvantage.

Exhibit 1 — Second Banking Directice

List of Banking Activities Subject to Mutual Recognition

1. Acceptance of deposits and other repayable funds from the public.

2. Lending
(including inter alia):
— consumer credits.
— mortgage credit.
— factoring, with or without recourse.
— financing of commercial transactions (including forfeiting).

3. Financial leasing.

4. Money transmission services.

5. Issuing and administering means of payment (e.g., credit cards, travellers' checks, and bankers' drafts).

6. Guarantees and commitments.

7. Trade for own account or for account of customers in:
(a) money market instruments (checks, bills, CDs, etc.).
(b) foreign exchange.
(c) financial futures and options.
(d) exchange and rate instruments.
(e) transferable securities.

8. Participation in share issues and the provision of services related to such issues.

9. Advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings.

10. Money broking.

11. Portfolio management and advice.

12. Safekeeping and administration of securities.

13. Credit reference services.

14. Safe custody services.

THE SECURITIES SECTOR

Summary

The first "Single Market" Directive in the investment services field based on mutual recognition was the one permitting "UCITS" (undertakings for collective investment in transferrable securities, akin to U.S. mutual funds) authorized in one member state to be sold in another member state. A single market for investment firms will begin January 1, 1996, when the Investment Services Directive (ISD) and the Capital Adequacy Directive (CAD) enter into force. The former establishes the single license for investment firms, while the CAD establishes essential minimum capital requirements deemed relevant for securities trading for both banks and investment firms. A directive establishing an investor protection scheme is under consideration. However, work on a pension fund investment directive, undertaken in the context of the single insurance market, has been set aside.

EU securities industry directives do not discriminate against firms established in Europe on the basis of nationality of ownership. Subsidiaries of U.S.-owned securities firms will be able to take advantage of the single passport. As in the banking industry, direct branches will not benefit from the single market, but will remain subject to member state regulation. Direct branches may not provide depositary services under the UCITS Directive.

The ISD, like the Second Banking Directive, includes a reciprocal national treatment clause under which the EU may deny a license to a company coming from a country that does not provide national treatment to EU securities firms. Established companies are grandfathered.

U.S. securities companies have expressed concern that although they will receive the same treatment under the ISD and CAD as do EU-owned firms, the 1996 entry into force of these directives puts them at a competitive disadvantage against universal banks, which already benefit from the single passport. Some firms also assert that the directives tend to reflect a bank regulator's approach to securities activities rather than the more flexible approach appropriate for the securities industry. This may be the case; however, it should be noted that some U.S. firms that are restricted to the securities business in the U.S. market have established banks within the EU. These banks have all the powers afforded in the single passport, including the ability to branch EU-wide and to offer investment services.

The Securities Industry in the European Union

Market Overview

In 1993, the total market value of United States equity markets was $5.2 billion. The comparable figures for the three largest EU markets, the United Kingdom, Germany, and France, were $1.2 billion, $463 million, and $456 million, respectively. The Netherlands and Italian markets recorded market values of $182 million and $136 million, respectively.

Presence of U.S. Institutions

There is no single authoritative source for data. The National Association of Securities Dealers reported that as of September 1994, there were 58 U.S. securities firms operating 113 branches in the EU (this includes branches of U.S. subsidiaries of foreign parentage). Nine of the U.S. firms had branches in more than one EU country. The largest presence was in the U.K., with 46 branches. A total of 34 branches were located in Germany, 16 in France, and 6 in Italy.

In late 1993, the Treasury Attache Office of the U.S. Embassy in London conducted an informal census of U.S. financial institutions in the U.K. The Securities and Futures Authority (SFA) reported that approximately 115 American securities firms were members (however, a number of these had the same U.S. parent). Of U.S. bank subsidiaries authorized by the Bank of England to accept deposits, three were owned by U.S. securities firms.

Single Market Legislation

The core of the single market in the securities field is the Investment Services (ISD) and Capital Adequacy Directive (CAD). The UCITS Directive was the first single market legislation in the financial services area to be enacted on the basis of mutual recognition. The EU is now considering an amendment to the UCITS Directive, as well as a directive on investor guarantee funds.

The "universal banking" approach in the Second Banking Directive establishes a single market in the securities sector for banks and other credit institutions. The Commission had hoped that a single passport would also be available for investment firms when the SBD entered into force at the beginning of 1993, but significant differences among the member states concerning such issues as access to regulated markets, capital standards for market risk, and transparency precluded adoption of the ISD and the CAD until later that year. These directives will enter into force January 1, 1996, three years after the creation of a single market for credit institutions.

The *Investment Services Directive* provides the single passport for investment firms. It spells out requirements for the authorization and supervision of investment firms, and lists covered services (brokerage, dealing, underwriting and portfolio management, and such "ancillary"

services as investment advice, underwriting services, and certain foreign exchange transactions — see exhibit 2 at the end of this section) and instruments (transferable securities, money market instruments, futures, forward interest rate agreements, swaps, options). The home country licensing authorities must ensure that investment firms meet minimum initial capital requirements, observe certain prudential rules, and adhere to capital adequacy standards with respect to market risk spelled out in the CAD.

On this basis, investment firms authorized in any member state may provide the covered services in the covered instruments in any other member state, under the supervision of the home state and without any additional authorization, although the home country must notify the host country of these activities. Services may be provided through branches or cross-border sales, and firms may advertise their services freely, subject to rules adopted "in the interest of the general good." Host member states must permit investment firms to become members of, or have access to, regulated markets and local clearing and settlement systems. Investment firms are subject to host country rules of conduct, and transparency and reporting requirements. As discussed in more detail below, the ISD also contains a reciprocal national treatment provision.

The *Capital Adequacy Directive* is one of the most technically complex pieces of EU financial services legislation. The CAD serves the purpose of four directives in the banking area, namely the Own Funds, Solvency Ratio, Large Exposures, and Consolidated Supervision Directives. A stated objective of the CAD is to achieve equality in the treatment of banks and investment firms with respect to investment services and activities. The CAD draws heavily on the provisions of the banking directives.

The CAD specifies minimum initial capital requirements for different types of investment firms, as well as rules governing capital standards for market risk for both investment firms and the securities activities of banks. In particular, the CAD establishes the concept of a "trading book." Detailed annexes in the CAD devise a system for measuring market risk in the trading book and the amount of capital to be held against this risk. Market risk is divided into four basic components: position risk (general and specific risks associated with debt and equity instruments, and underwriting risk); settlement and counterparty risk; foreign exchange risk and "other" risks.

The CAD also sets forth requirements concerning the "own funds" of investment firms, the monitoring and control of large exposures, the valuation of positions for reporting purposes, consolidated supervision and reporting requirements. The directive, however, does leave home country regulators considerable scope for interpreting or applying their provisions.

The EU's effort to incorporate in one directive detailed rules on such complex regulatory issues is ambitious. It is a ground-breaking endeavor, for there are no international precedents for market risk standards similar to those established for credit risk by the Basle Committee. Some firms that will be subject to the CAD's rules have expressed concern that these may need to be

modified in the event an international accord is reached at a future date. This would impose additional costs that are said to be substantial already in the development of systems needed to meet the CAD's requirements. To date, international securities regulators have not agreed on minimum international standards. Members of the U.S. Securities and Exchange Commission have said that the CAD's capital standards fall below minimum U.S. requirements.

In a related area, the Commission is studying the possibility of clarifying the capital adequacy treatment of the commodities and commodity derivatives trading activities of banks and investment firms.

Pursuant to the ISD, the Commission recently has proposed an *Investor Compensation Directive* to parallel the Deposit Guarantee Directive adopted for the banking industry. The directive requires member states to establish a scheme or schemes to compensate investors up to at least ECU 20,000 ($22,000) in the event an investment firm becomes bankrupt or defaults (even if by fraud). All authorized investment firms and credit institutions providing investment services would have to belong to such a scheme. Branches located in other member states would be covered by the scheme to which their parent belongs; an expatriate branch would be allowed to "top up" coverage in a host state scheme if it wishes. Coverage of branches of investment firms based outside the EU ("third country branches") would be at the discretion of the individual member states. The directive is meant to enter into force on January 1, 1996, at the same time as the ISD, but progress on it has been slow.

The measures described above are directed specifically toward providers of investment services. The *Pension Funds Directive* (proposed as part of the single insurance market) was to focus on one of the major institutional consumers of investment services, i.e., pension funds. In particular, the proposed directive would prevent member states from requiring pension funds to use locally based investment managers and depositories. Any financial institution with a single passport would be able to act as investment manager while a bank, investment firm or institution authorized under the UCITS Directive could be a depository. The directive would further limit the ability of member states to require pension funds to invest in domestic assets or assets denominated in local currency, requirements that frustrate free movement of capital. However, the inability of member states to agree upon a percentage limit for the local currency asset requirement has led to a suspension of discussions on this directive.

The *UCITS Directive*, adopted in 1985, created a single market for "undertakings for collective investment in transferable securities" (similar to diversified, open-ended mutual funds found in the United States), effective October 1, 1989. The directive establishes minimum essential rules governing the authorization of UCITS, their structure and capitalization, the choice of depository, investment and borrowing policies, and information to be provided to investors. These rules then allow for mutual recognition, permitting a UCITS authorized in one member state to market its shares in other EU countries without further authorization.

The Commission recently proposed that the directive be amended to, inter alia, include "master feeder funds" and "cash funds," expand the scope of permissible depositories to include direct branches of third country banks established in a UCITS home state and any credit institution or investment company operating in the EU under a single license, and permit UCITS to transact in financial derivatives. This proposal is under consideration by the Council and the European Parliament.

Treatment of U.S. Investment Firms Under EU Law

The directives described above do not distinguish among firms based on the nationality of their ownership. Thus, already established EU subsidiaries of U.S. securities firms receive national treatment under these EU laws.

Reciprocity

The ISD, however, includes a reciprocal national treatment provision. As is the case under the Second Banking Directive (on which the ISD provision is modeled), this provision requires the Commission to draw up regular reports on the treatment received by EU investment firms in third countries; to consider negotiations with these third countries if they deny "effective market access comparable to that granted by the EU;" and to enter into negotiations if a third country denies national treatment to EU firms. Where a third country denies national treatment, the Commission may instruct member states to suspend or deny for a period of three months applications for new authorizations or for acquisitions from firms from the third country; this may be extended by a qualified majority of the Council.

This reciprocal national treatment clause does not become effective until the beginning of 1996 when the ISD enters into force. The EU Commission has not identified any denials of national treatment in the United States that would lead it to invoke this clause to the detriment of U.S. securities firms. However, the EU has complained that the separation between investment and commercial banking denies EU universal banks "effective market access" to the securities business in the United States.

Treatment of Branches

As in the banking area, an important issue arises because direct branches are not covered by the provisions of the Single Market Directives. The activities of a U.S. firm cannot be supported by the capital of the parent unless direct branches are established in each of the 12 member states. In seeking authorizations to establish and operate, firms remain subject to distinct national reciprocity tests. Local capital and other requirements might vary from country to country. National regulations might preclude branches from undertaking all of the activities that holders of the single license are entitled to.

Compared to banks, relatively little has been heard from U.S. securities firms concerning difficulties that might arise out of noncoverage of direct branches by the single license. However, it is of interest to note that foreign securities firms in Germany are seeking a provision in the implementing legislation for the Investment Services Directive that will provide direct branches with certain of the benefits provided to single license holders (e.g., elimination of local capital requirements).

Another potential problem related to direct branches arises in the area of depositories: the UCITS Directive stipulates that depositories must have their registered office in a member state, which effectively excludes third country direct branches from this business. The proposed Pension Funds Directive echoes this by tying the depository to banks and investment companies having a single passport or to depositories accepted under the UCITS. As noted earlier, however, the Commission has proposed eliminating the UCITS restriction on the ability of direct branches to act as depositories in a UCITS home state. However, authorization would need to be obtained on a home state-by-home state basis.

Universal Banks vs. Securities Firms

U.S. securities firms are more concerned about being disadvantaged against universal banks, which will have benefitted from the single passport for three years before the ISD and CAD enter into force, than they are about direct discrimination. This problem, which applies equally to European-owned securities firms, is diminished to some extent as Belgium, France, and Italy will not permit banks access to their stock exchanges until the end of 1996. Greece, Portugal, and Spain may delay bank access to their stock exchanges until the end of 1999. Moreover, bank "trading book" activity is subject to the provisions of the Solvency Ratio Directive until the CAD comes into effect.

For the longer term, some U.S. securities firms view the CAD in particular as tending to reflect an unnecessarily strict bank regulator's approach to capital adequacy, rather than the more flexible approach appropriate for securities firms. Some U.S. companies, for instance, have noted that in the highly developed securities markets of the United States and the United Kingdom, high quality short-term subordinated debt is used extensively to satisfy regulatory capital requirements (it is not used for bank capital). The CAD will allow universal banks to use this debt as capital for their "trading book" activities, but will effectively reduce and limit the extent to which securities firms may do so. Similarly, the CAD's "bank-style" consolidated supervision approach ignores the fact that securities firms are often associated with nonregulated affiliates. Subjecting these affiliates to consolidated supervision may place them unnecessarily at a disadvantage to those competitors that are not affiliated with a securities firm.

As both the ISD and the CAD allow considerable discretion in implementation, bank-derived regulatory approaches to investment firms may become more evident as these directives are transposed into national law. Adoption of a narrow definition of "trading book," for instance,

would mean some "non-trading book" investment firm activities would require more costly forms of capital designed to support credit risk oriented banking activity. Similarly, there is concern that the "conduct of business" rules that member states draw up may not make appropriate allowance for the sophistication of institutional investors, and that the provisions related to investor consent for "off-exchange" transactions will be unnecessarily burdensome.

A further concern with the ISD, which again affects all investment firms equally, is that "foreign exchange services" benefit from the passport only when connected with the provision of the "core" services of dealing, brokering, underwriting, and portfolio management. The SBD does not similarly limit bank foreign exchange activity. Investment
firms also are concerned that some member states may require the connection between foreign exchange services and core services to be so tight that it will impede their ability to do conduct normal business.

These concerns at a minimum make the case for affording potentially affected parties adequate opportunity to present their views both when the framework legislation is being formulated and when it is being transposed into law at the national level. However, given the general complexity of the issues, the range of financial institutions with diverse interests that will be affected, and the legitimacy of prudential concerns, it is difficult to draw conclusions concerning potential denials of national treatment.

Exhibit 2 — Investment Services Directive

List of Investment Services and Instruments Subject to Mutual Recognition

Section A

Services

1. (a) Reception and transmission on behalf of investors, of orders in relation to one or more of the instruments listed in section B.

   (b) Execution of such orders other than for own account.

2. Dealing in any of the instruments listed in Section B for own account.

3. Managing portfolios of investments in accordance with mandates given by investors on a discriminatory client-by-client basis where such portfolios include one or more of the instruments listed in Section B.

4. Underwriting in respect of issues of any of the instruments listed in Section B and/or the placing of such issues.

Section B

Instruments

1. (a) Transferable securities.
   (b) Units in collective investment undertakings.

2. Money market instruments.

3. Financial futures contracts, including equivalent cash settled instruments.

4. Forward interest rate agreements (FRAs).

5. Interest rate, currency and equity swaps.

6. Options to acquire or dispose of any instruments falling within this section of the Annex, including equivalent cash settled instruments. This category includes in particular options on currency and on interest rates.

Section C

Non-core services

1. Safekeeping and administration in relation to one or more of the instruments listed in Section B.

2. Safe custody services.

3. Granting credits or loans to an investor to allow him to carry out a transaction in one or more of the instruments listed in Section B, where the firm granting the credit or loan is involved in the transaction.

4. Advice to undertakings on capital structure, industrial strategy and related matters and advice and service relating to mergers and the purchase of undertakings.

5. Services related to underwriting.

6. Investment advice concerning one or more of the instruments listed in Section B.

7. Foreign exchange service where these are connected with the provision of investment services.

FINANCIAL MARKET DISCUSSIONS

In 1993, the U.S. Treasury Department and the European Commission established a forum for discussing financial markets issues of mutual interest. For the three rounds of the dialogue that have been held to date, the U.S. and Commission delegations were led, respectively, by the Assistant Secretary for International Affairs and the Director-General of DG-XV (Internal Market and Financial Services).

The first round of the dialogue took place in October 1993 in Washington, DC, at the Treasury Department. The EU delegation raised regulatory issues in the U.S. market, including U.S. regulators' latitude for expanding banks' nonbank activities under Glass-Steagall, the administration's plans for Fair Trade in Financial Services legislation and for legislation to permit interstate banking and branching, and regulations that had been proposed by the Federal Reserve Board, pursuant to the Foreign Bank Supervision Enhancement Act, that would impose a fee on Federal Reserve examinations of branches and agencies of foreign banks. The U.S. delegation requested a report on the status of implementation of the EU's single market legislation for financial services and, in particular, expressed concern about the desirability of greater transparency and public consultation in the EU's rule-making processes. Given the nature of the issues on the agenda, the U.S. delegation also included the Assistant Secretary of the Treasury for Domestic Finance and representatives of the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Securities Exchange Commission.

The second round of the dialogue took place in February 1994 in Brussels at the Commission headquarters. The discussion focussed on the status of the Uruguay Round financial service negotiations. Both sides expressed dissatisfaction with the financial services offers that had been tabled in December 1993. They agreed that significant improvements in market access and national treatment commitments should be sought in a large number of commercially important industrial and developing country markets. They also agreed to consult closely in the period leading up to and during the first six months after the entry into force of the Uruguay Round agreement, by which time market access and national treatment offers in financial services must be finalized. The third round of the dialogue was scheduled to take place in Washington on November 2, 1994. The agenda included discussion of the status of international financial services negotiations, and recent developments regarding the EU Financial Services Directives and U.S. banking regulation.

EEA — SYNOPSIS OF DEVELOPMENTS

Austria

Most financial services laws and regulation have been brought into conformance with those of the EU. Austria's 1993 Banking Act distinguishes between banks holding a banking license from EEA and non-EEA countries. Branches of non-EEA banks must be licensed and approvals are subject to reciprocity criteria. Beginning December 31, 1998, both branches and subsidiaries of foreign banks will become subject to a capital rule that will lower the limits for large exposure and open foreign exchange positions.

Belgium

A long-standing Belgian practice prohibits foreign firm organized as branches from soliciting securities business from Belgian nationals and requires Belgian business to be booked through Belgian stockbrokers.

Finland

Finnish financial services liberalization has been conducted both independently and in the context of EEA implementation. In 1991, Finland removed restrictions on branching by foreign banks. While subject to a three-year transition period, Finland has removed limitations on inward direct foreign investment. Approvals for foreign banks are subject to reciprocity criteria.

France

Although up-to-date in implementing EU eirectives, some differences of interpretation have appeared. The French authorities have made clear their preference that services provided on a regular basis be from within France and not cross-border. The language in implementing legislation for some directives implies that a "mirror image" reciprocity approach will be followed when granting licenses for branches of non-EEA foreign banks. The French market could benefit from greater transparency in regulation.

Germany

Germany's endowment capital requirement for foreign bank branches was quite costly and put non-EU banks at a competitive disadvantage once the requirement was eliminated for EU banks under the Second Banking Directive. However, after bilateral discussions between German and U.S. regulatory authorities, a decree was issued eliminating the problem for U.S. banks. Remaining outstanding issues include restriction on cross-border data processing and German regulators' reluctance to authorize new financial products.

Greece

The Greek banking industry is dominated by a few state-controlled banks, but has a competitive private sector comprised of Greek and foreign banks. Greece imposes discriminatory minimum capital requirements on branches of U.S. and other non-EEA banks and applies a reciprocity test. Only one American securities firm operates in Greece, and it offers only offshore products. Authorizations for foreign securities firms are subject to a reciprocity test.

Italy

The Italian SIM law's incorporation requirement provides an example of how the liberalizing intent of the single market may not be practiced at the national level. While the issue is more intra-EU than one of national treatment, U.S. securities firms located elsewhere in the EU have been adversely affected by the SIM requirement. Local capital requirements continue to apply to branches of non-EEA banks putting them at a competitive disadvantage relative to EEA incorporated banks.

Netherlands

According to the Ministry of Finance, Dutch law and regulation applies on a completely nondiscriminatory basis. Foreign providers face no special conditions or restrictions. Although Dutch legislation does contain a reciprocity provision, it has never been used against a non-EU applicant. Branches of non-EEA banks are subject to regulation that potentially could be stricter than that for EEA banks.

Norway

Prior to entry into force of the EEA, foreign banks could not establish branches in Norway. Currently, branches of EEA incorporated institutions, including those of U.S. subsidiaries, are eligible to enter. A prohibition remains on branching by non-EEA banks and securities firms. However, the government will propose legislation to abolish this restriction as of January 1, 1995.

Portugal

After Portugal's accession to the EC in 1986, the financial sector was dramatically reformed; the majority of the formerly nationalized system is now in private hands. Portugal generally limits non-EU foreign acquisition of these entities to a 25 percent share. American presence in the market remains modest, apparently by choice, as no other significant impediments to entry or operations have been noted other than those concerning privatized banks.

Spain

Spain welcomes the entrance of foreign banks and securities firms, which are generally treated the same as Spanish firms after establishment. However, foreign bank branches are subject to local (dotation) capital requirements, putting them at a disadvantage against EEA banks.

Sweden

Sweden has substantially liberalized its financial sector during the past 10 years. In 1990, foreign-owned banks were permitted to enter as subsidiaries or branches. Foreign securities firms were authorized to open branches in 1991. Under the EEA accord, Sweden is obliged to introduce the Second Banking Directive's reciprocity provision; however, it has not done so pending the outcome of the GATS financial services negotiations. Swedish authorities have stated that any EEA-related liberalization will be implemented erga omnes.

Switzerland

Although not a member of the EEA, Switzerland's financial services legislation largely conforms to EEA norms. No impediments are placed on entry of foreign firms, or on activities post-establishment. However, entry is subject to a reciprocity test.

United Kingdom

The U.K. has implemented all EU directives as required. The process of implementing the directive into U.K. law has been open and iterative. The major presence of foreign firms in London is indicative of the openness of the market.

BELGIUM

SECURITIES

SUMMARY

Over the past few years, Belgium's securities markets have undergone a number of regulatory and structural changes. The overall objective of these changes has been to integrate the domestic market within the European Union, manage the government's very large national debt burden more efficiently, and foster more competition in the industry.

Two official institutions, the Banking and Finance Commission and the National Bank of Belgium, jointly supervise Belgium's securities industry. The Brussels Stock Exchange regulates itself through three committees; a private service, the Stock Exchange Companies Security Fund, examines listed companies.

The government remains the predominant issuer of bonds. Treasury government paper sales set a record of BF 1530 billion in 1993 as compared to BF 1107 billion in 1992. Despite a severe recession in 1993, the worst in the post-World War II period, shares appreciated on the country's main stock exchange (the Brussels Stock Exchange) by nearly 37 percent as low interest rates and prospects for future improvement in corporate profitability began to renew investor interest in the equity market. In addition to the Brussels and Antwerp stock exchanges, an over-the-counter market, although not officially recognized by the other exchanges, is nevertheless widely used for trading both debt and equity. Options and futures are traded on Belfox, the Belgian futures and options market, which also saw record activity in 1993.

At present, the Belgian financial market has limited appeal to U.S. financial institutions. A longstanding Belgian practice prohibits foreign firms organized as branches from soliciting business from Belgian nationals and requires that Belgian business be booked through Belgian stockbrokers (which adds to transactions costs). While the market is seen as being too small and specialized to warrant major investment, the two U.S. securities firms in Belgium, Prudential Securities and Merrill Lynch, focus their efforts on a small niche market consisting of expatriates. This situation may change by 1996, as Belgian laws are changed to conform with the European Union's Financial Services Directives.

There are no capital controls that restrict residents' access to overseas markets either as issuers or as investors, nor are there any restrictions on nonresidents' access to the Belgian securities market.

DESCRIPTION OF THE MARKET

Regulation

Two public institutions jointly regulate the Belgian securities market: the Banking and Finance Commission (BFC) and the National Bank of Belgium (NBB, Belgium's central bank). In addition, the Brussels Exchange is a self-regulated body; and a private service, the Stock Exchange Companies Security Fund, examines listed companies.

In addition to its responsibilities for supervising banks, the BFC also regulates Belgian capital markets. As such, it is the nearest Belgian equivalent to the U.S. Securities and Exchange Commission.

The NBB issues notes, sets and implements monetary policy, manages gold and foreign exchange reserves, acts as a lender of last resort to banks, handles treasury expenditures and receipts, and assumes responsibility for the administration and accounting of government bonds. In addition, the NBB provides for the clearance and settlement of all government securities and has fiduciary control over the securities market.

The Brussels Exchange is a self-regulated organization supervised by three committees. The Stock Exchange Committee, which also serves as the Brussels Stock Exchange Board of Directors, comprises brokers that supervise general exchange activities. The three-member Quotations Committee, appointed by the Stock Exchange Committee, supervises the execution of orders by brokers and intervenes in trading during periods of extraordinary price volatility. The Listings Committee, whose members are appointed by the Ministry of Finance, approves issues for listing on the exchange, reports listing requirements, and delists issues.

By agreement among members of the securities industry, the Stock Exchange Companies Security Fund maintains wide investigative and inspection powers over the management, financial situation, and compliance of stock exchange companies. The Securities Regulation Fund safeguards individual investors by guaranteeing liquidity in the secondary market.

In order to issue equity on the stock exchange, companies must comply with the three royal decrees of September 22, 1990, and the royal decree of January 18, 1991. The Royal decrees are designed to bring the Brussels stock exchange into conformity with EU Single Market Directives. Inter alia, they set stricter capital requirements for stock exchange firms, open the Brussels stock exchange to non-Belgian brokers, and allow banks to become shareholders in stock brokerage firms. The royal decrees also were meant to discourage widespread off-bourse trading in shares, but success to date has been limited.

The Bond Market

The Belgian government's very large structural budget deficits of recent years (6.5 percent of GDP in 1993) have been financed through issuance in the bond market. Belgium's total outstanding national debt reached BF 9,280 billion in June 1994, equivalent to roughly 125 percent of GDP — one of the highest proportions in the European Union. Confidence in government paper has been underpinned by the formal commitment to link the Belgian franc to the Deutschemark in June 1990. However, with Belgium now on the periphery of the Netherlands-Germany "hard bloc" within the Exchange Rate Mechanism, this link has become more difficult to maintain.

In response, the government has undertaken a number of reforms during the last three years for the purpose of fostering integration of Belgium with the rest of Europe, and for the purpose of reducing the burden of public debt. Efforts to modernize the government bond market include reducing the withholding tax, introducing a new homogenous class of securities, establishment of an automated clearing system (organized by the NBB), and establishment of a group of 15 dedicated primary dealers to "make markets" in government bonds.

The government remains the predominant issuer of bonds. The main participants are Belgian and Luxembourg financial institutions and Belgian stockbrokers. The Kingdom of Belgium and the Fonds Des Routes (a government agency that finances highway construction and last issued in 1988) account for 90 percent of government bond issues. Other government agencies and supranational organizations (such as the World Bank) account for the remaining 10 percent.

The two types of government bonds are Belgian Government Bonds (BGBs, also called traditional bonds) and obligation lineaire (OLOs), both of which are traded mostly over-the-counter. BGBs, which account for 13 percent of the market, are fixed-rate, callable or noncallable straight issues intended for private retail investors. Since 1990, these bonds have been issued three to four times each year, with the Ministry of Finance determining the coupon rate and issue price, and with financial institutions, formerly used as underwriters in a consortium, placing the issues. BGBs are not tax-exempt for nonresidents unless registered with the Ministry of Finance.

An important innovation in 1989 was the creation of OLOs,[1] essentially straight bonds with a fixed-rate and annual coupon intended for Belgian as well as foreign investors. Issued by Treasury tender, OLOs constitute the government's most important financing instrument. With features such as immediate assimibility, perfect fungibility in terms of coupon and maturity, noncallability, ease of purchase and delivery, and representation either by book entry in the clearing system or in the main register of the public debt, OLOs are homogenous and therefore very liquid. These bonds are exempt from withholding tax for all investors except Belgian

[1] This instrument is similar to the France's Obligations Assimilables du Tresor (OATS).

pension funds and nationals. Treasury OLO sales set a record of BF1530 billion in 1993 as compared to BF1107 billion in 1992.

There are several other types of instruments offered in the bond market. Straight bonds (of which traditional bonds and OLOs are but two examples) are long-term loans, usually in bearer form, issued by the government, local authorities, public institutions, and occasionally by private companies. Cash bonds are short- to medium-term instruments issued by public or private financial institutions. There are several types with varying maturities and interest payment differences. Convertible bonds may be converted into equity. Lottery bonds allow the holder to participate in a lottery to receive a complimentary amount. Participating bonds entitle the holder to a portion of the company's profits in addition to normal interest. Certificates of conversion must be converted by the holder to equity by the end of the holding period.

The Equity Market

Belgium has three stock exchanges. The first is the Brussels Stock Exchange (BSE, the National Exchange), incorporated and owned by the members of the Societe De La Bourse (The Exchange Society). The second, in Antwerp, specializes in regional securities. The third, although not officially recognized by the other two exchanges, is the over-the-counter (OTC) market. Most debt instrument trades, and a large portion of equity trades, are executed over-the-counter. OTC trades are negotiated between buyers and sellers and are not subject to the price set by the stock exchange, except that trades must exceed a minimum amount of BF 25 million, determined by the BFC and the Stock Exchange Committee.

Equity instruments may be of three types: common, preferred, or Avantage Fiscal Voordelen (AFV — shares issued in 1982 and 1983 with fiscal advantages for residents). Most equities are in bearer form; registered equities are rare.

Major issuers on Belgian stock exchanges, in descending order of participation, are holding companies, electric and gas companies, financial services firms, oil companies, and chemical companies. The largest individual company listed on the BSE (and the most actively traded stock) is Electrabel. The top 25 companies listed on the main exchange, the BSE, account for 89 percent of turnover.

On the BSE, Belgian and non-Belgian equities and corporate bonds are traded on two different markets: (1) the official market, which includes the cash and the forward markets, and (2) the "second" market, which comprises 10 securities of small or medium-sized Belgian or foreign companies (and on which prices are fixed once daily by auction).

The official market is divided into the forward (also called continuous) market and cash (spot) market. All Belgian and non-Belgian equity trades on the forward market are traded

electronically through the Computer Assisted Trading System (CATS). Forward market trades must be for a fixed quantity or some multiple thereof.

All securities listed on the official market may be traded on the cash market, but the most important securities usually trade on the forward market (where most non-Belgians are active).

The cash market is subdivided into the cash bond, cash ring, and cash floor markets. All state, provincial, and public service bonds are traded in the cash bond market. Since 1991, a CATS system called Oblicats is increasingly used for government bond trades exceeding BF5 million (currently $1 equals about BF35). Bonds traded outside Oblicats must meet a BF 1 million minimum per trade. The Cash Ring Market is where the most active cash market equities are traded. Trading is open outcry with market makers. Prices may vary, but they seldom do. The Cash Floor Market is reserved for equities not traded actively. Only one price is quoted daily.

Despite Belgium's worst economic recession since World War II and a contraction of GDP by 1.3 percent, the Brussels stock market rose steadily throughout most of 1993. Two indices are commonly used to measure performance: the Cash Market All-Share Index and the Forward Market All-Share Index. Both are weighted indices based on the capitalization of each officially listed company. As of October 31, 1994, the Cash Market index stood at 7,225 (up from 1,000 on January 1, 1980) and the Forward Market index stood at 1,382 (up from 1,000 on December 30, 1991).

Total equity capitalization of the Brussels stock market amounted to BF2,819 billion in 1993, slightly more than 30 percent of GDP. Two other indices are Belgium's Return Index of all listed Belgian securities, which rose 35.7 percent in 1993, and the more narrow Bel-20 Index, derived from a basket of twenty leading shares, which rose 26 percent in 1993. In the primary market, new issues on the BSE amounted to BF 23 billion last year. Secondary market turnover of BF484.4 billion in 1993 surpassed levels recorded in 1990, 1991, and 1992.

A negative trend over the past four years has been a steady delisting of companies on the BSE, from 185 in 1989 to 159 in 1993. Authorities have responded by introducing reform to enhance competition in the securities industry, improve investor protection, and deter insider trading. In October 1993, the government launched a four-year privatization program to sell off state assets, with the larger aim of broadening and diversifying the equity market structure in Belgium. Despite forecasts of relatively low growth in 1994 vis-a-vis the rest of Europe, expectations of a strong recovery in corporate profits, low inflation, falling interest rates and sustained recovery in Europe will likely encourage more investment in Belgian shares going forward.

The Belgium futures and options market (Belfox) launched over-the-counter OLO options trading (supervised by the NBB) in 1991, and in 1992, trading in OLO swaps. Options and futures trading through a fully operational computerized system started on Belfox in mid-1992. Belfox

is designed to allow for the trading of futures on government bonds, options and futures of the Bel-20 stock index, and options on individual stocks. Belfox members may be public order members (to execute an order through a broker), brokers (who can execute orders as a principal or as an agent of a public order member), or market makers (who may only execute orders as principals). After a slow start (due to computer software problems and an insufficient number of primary dealers), the market reached its profit target in September 1993. The Bel-20 Index option was heavily traded last year; more active trading generally was spurred by the abolition of a fixed commission structure, removal of the brokering and market-making stronghold of Belgian and Luxembourg brokerage houses, and expansion of the range of permitted instruments (such as the addition of commodities futures).

U.S. PRESENCE IN THE MARKET

Of the three U.S. banks in Belgium, only Citibank engages in securities business, mainly mutual funds, which have grown sharply in recent years. However, its market share remains less than 1 percent of the total domestic securities market.

Two U.S. securities firms, Prudential Securities and Merrill Lynch, concentrate on the Belgian expatriate market. Clients seek the services of the firms for access to securities markets outside of Belgium, primarily the U.S. market. Client accounts are booked offshore through London or New York offices. Both firms are established in Belgium as branches, although the option of establishing a subsidiary is available.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no limitations on foreign subsidiaries or on foreign acquisitions of existing firms in the securities sector. Foreign-owned firms are regulated in the same manner as domestic firms and may become members of the stock exchanges. The firms may offer the same financial products and services as domestic firms, including fund management.

With regard to branches, a long-standing Belgian policy prohibits foreign securities firms organized as branches from soliciting Belgian clients, although Belgian nationals are free to contract the services of these establishments if they wish. However, any business conducted with Belgian nationals must use a Belgian stockbroker as intermediary. The latter stipulation increases transactions costs, reducing the attractiveness of overseas investment through U.S. securities firms. In addition, branches of foreign securities firms may not become members of Belgium's stock exchanges or provide depository services.

In view of such deterrents as the additional transactions costs and the restriction of actively generating business from Belgian nationals, U.S. firms' activity in Belgian securities markets remains limited to the expatriate community.

Given their generally circumscribed objectives in the Belgian securities market, no U.S. financial institution operating there has complained that law or practice restricts their business in Belgium. At present, U.S. firms see the Belgian securities market as too small and too specialized to warrant a major investment of resources.

The EU's Investment Services Directive, expected to enter into force in 1996, will allow EU-based securities firms, including U.S. subsidiaries, to conduct business with Belgian clients either through branches or on a cross-border basis. As a result, some of the above-mentioned restrictions may no longer apply.

GREECE

BANKING

SUMMARY

Any discussion of banking and finance in Greece must take into account Greece's enormous public debt and public sector deficits. At the end of 1993, the public sector debt was estimated at 160 percent of the Gross Domestic Product (GDP), and the Public Sector Borrowing Requirement (PSBR) was officially projected to be 14 percent of GDP in 1994. Other estimates of the PSBR range as high as 17 to 19 percent of GDP. As a result, real interest rates are extremely high. Public borrowing crowds out private borrowing, and government securities are the dominant investment vehicle.

The Greek banking industry is dominated by a few state-controlled banks. However, a competitive and generally profitable private sector comprised of Greek and foreign banks is developing.

The banking and financial sectors have liberalized considerably since 1987, primarily because of directives from the European Union (EU). Liberalization of short-term capital movements, effected on May 16, 1994, was the last step towards a free market banking system. Transparency has improved in the past few years as weil.

Greece imposes discriminatory minimum capital requirements on U.S. and other non-EU banks establishing in branch form. Branches of banks from EU countries, including those of EU subsidiaries of U.S. banks, are not subject to these requirements. All four U.S. banks operating in Greece are established in branch form, however. They will be required to meet the capital requirements.

Some U.S. banks feel that Greece's large state-owned banks may have certain indirect competitive advantages because they are not subject to market pressure to earn a profit. It is sometimes argued that this has contributed to the difficulties that foreign and smaller private Greek banks have had in raising drachma deposits. Similarly, it is felt that regulations and rules might be devised in a manner that benefit the large state-owned banks to the detriment of small Greek and foreign banks. On the other hand, state-owned banks are subject to pressures on their operations that may increase their costs and restrict their ability to compete for profitable private sector business.

DESCRIPTION OF THE MARKETS

Recent Liberalization and Developments

Greece's banking system has a legacy of government control and government interference that is now eroding under recent competitive pressures and the need to adopt the EU Financial Services Directives. Significant liberalization and deregulation has taken place since 1987 to prepare the country's banking system for the dismantling of all barriers to the free flow of capital within the EU. Liberalization of the banking system has included:

- Dismantling the system of reserve requirements and regulated interest rates;
- Reducing the role of the Central Bank in dictating bank lending;
- Developing active capital markets;
- Developing competition between banks; and
- Abolishing selective credit controls and liberalizing the offering of new financial products.

The three largest state-controlled banks, the National Bank of Greece, the Commercial Bank of Greece, and the Agricultural Bank of Greece, controlled approximately 61 percent of bank deposits and 49 percent of bank loans at the end of 1993. When all 15 state-controlled banks and specialized financial institutions are aggregated, the market share increases to 77 percent for deposits and 75 percent for loans. The 22 foreign-owned banks, including 12 EU-based banks, control 12 percent of bank deposits and 14 percent of bank loans. The 12 private Greek-owned banks have the remaining 11 percent of deposits and 11 percent of loans. All banks are regulated by the Ministry of Commerce, while supervision is carried out by the central bank.

State-Controlled Banks

The 15 state-controlled banks have a high level of nonperforming loans, which disclosure requirements have been only partially effective at uncovering. Although state-controlled banks may not provide the highest level of service, they do offer attractive deposit and lending rates. Profitability of the state-controlled banks is low relative to private Greek and foreign banks. Competitive pressures are gradually forcing the state-controlled banks to modernize their labor and technology standards and to become more market-oriented.

The state-controlled banks generally have a high ratio of deposits to loans, i.e., they make few loans relative to deposits. As noted in the summary, Greece has a large public sector borrowing requirement. Much of this borrowing is funded by issuance of government securities. State banks play an important role in the funding process by using deposits to acquire these securities.

This tends to reduce lending to the private sector by state-controlled banks. This can be seen clearly with the largest state-controlled bank, the National Bank of Greece, which has roughly 38 percent of the banking system's deposits but only 18 percent of the system's loans. Most other state-controlled banks show a similar pattern.

The exception to the large deposit-to-loan ratios generally seen in the state-controlled bank is the Agricultural Bank. Its deposits are 13 percent of the market, but it has made 24 percent of all loans. The government uses this bank to give high-risk loans to agricultural cooperatives, in effect providing them with a subsidy.

Two state-controlled banks have been mentioned in the financial community as candidates for injections of capital in the $1 billion range: the Agricultural Bank of Greece, cited above, and the Hellenic Industrial Development Bank (ETVA). ETVA posted a loss of roughly 60 billion drachmas (240 million dollars) in 1992.

Deposit Insurance

Greece does not currently have a deposit insurance system, but the issue is being debated. There is consensus between the government and the banking community in favor of deposit insurance; however, there are disagreements over the level and cost of the coverage.

ATMs

Automated teller systems are just beginning to be introduced in Greece.

U.S. PRESENCE IN THE MARKET

There are four U.S. banks operating in Greece as branches. Citibank is by far the largest U.S. bank, as well as the largest foreign bank, holding 3.37 percent of total deposits of the banking system and 1.23 percent of total loans at the end of 1993. Citibank also operates a bank subsidiary specializing in shipping loans, and has insurance, leasing, and credit card subsidiaries.

U.S. banks have had a presence in Greece for approximately 25 years, and are enjoying solid profitability. Each of the four U.S. banks has a market niche providing value-added services based on their wide range of products and high technology support. Citibank operates 19 branches and plans to expand to 24 branches by 1997. American Express Bank operates seven branches. The other U.S. banks, Chase Manhattan and Bank of America, operate one to two branches. The markets they pursue are high net-worth individuals for private banking services and mutual funds, and commercial lending to high quality Greek and multinational corporations. In addition, U.S. banks offer clearing services, correspondent relationships, and foreign exchange activities.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no legal constraints on U.S. or foreign (non-EU) ownership of bank subsidiaries other than those applying equally to Greek and EU subsidiaries. Establishment of subsidiaries is conditioned upon the EU's common reciprocity test.

In addition to a reciprocity test, the establishment of non-EU direct branches is subject to the following conditions:

- To establish four branches or more, a non EU-bank must have capital equivalent to a Greek bank's requirement of four billion drachmas ($16.7 million). This requirement is reduced by 50 percent if fewer than four branches are established.

- There must be at least two adequately qualified residents of Greece responsible for management.

Since banks established in other EU countries do not have to meet the capital requirement for the establishment of a branch, this requirement is discriminatory against all non-EU banks, including those from the United States. For existing branches of foreign banks, a deadline has been given to meet capital requirements. However, the Bank of Greece has applied it flexibly.

Another regulation favoring EU banks is the capital requirement for letters of credit. According to Greek government regulations, banks can guarantee up to 25 percent of their outside loans. The point of discrimination is that for EU banks, parent company loans are included, but for non-EU banks, only loans by the local branch are counted. Both the current and prior Greek governments have said they would change the relevant regulation, but they have not done so yet.

Restrictions on capital movements between Greek residents and residents of EU and non-EU countries were, for the most part, liberalized by a Presidential Decree in 1993. On May 16, 1994, the remaining restrictions on short-term capital movements were abolished. Certain administrative requirements remain (mainly for provision of statistical information on the transaction and confirmation that the transferee has no outstanding overdue tax liabilities to the Greek State).

There are no specific restrictions on the introduction of new financial products. However, the markets are relatively underdeveloped in this respect. The Bank of Greece requires reporting of loan maturity profiles of credit institutions for supervisory purposes.

Greece is in the process of automating its check clearance system. U.S. bankers expressed concern that the fee schedule for this service, when implemented, could discriminate against U.S. banks because of their small size. A high fee for use of the clearing system would favor

the large banks and penalize the small banks, including U.S. banks. This is not seen as being aimed at U.S. banks, but rather at small banks in general, as an attempt by the larger banks to protect market share.

A final area which may pose a problem for U.S. and foreign institutions is taxation. A tax bill passed in April 1994 raises the corporate tax rates for companies not listed on the Athens Stock Exchange to 40 percent, while maintaining the current 35 percent rate for listed companies. Although not directly aimed at U.S. or foreign institutions, this legislation penalizes U.S. banks doing business in Greece by making them pay a higher tax rate than that imposed on some of their competitors.

In total, the direction of the government policy, driven by EU legislation and liberalization of financial markets overall, is advancing towards the creation of a much more level playing field.

U.S. bankers have indicated that they have the opportunity to informally comment to the authorities on changes and/or become adequately informed of changes in the rules and regulations.

1993 Percentage Market Share by Sector
(excludes representative offices)

Type of Bank	Number	Deposits	Loans
State-Controlled	8	56	32
State Development Banks	3	0	8
Specialized Institutions	4	21	35
Total State-Controlled	14	77	75
Greek Private	12	11	11
EU (Non-Greek)	12	6	10
United States	5	5	3
Other Foreign	5	1	1

1992 Summary Financial Data by Sector
(millions of U.S. dollars)

Type of Bank	Net Worth	Total Deposits	Total Loans	Total Assets	Net Income[1]
State - Controlled (8/8 reporting)	1,663	35,063	30,550	75,282	314
State Development (3/3 reporting)	119	0	2,451	2,451	-235
Specialized Institutions (3/4 reporting)	846	10,729	11,303	16,030	-4
Greek Private (10/11 reporting)	600	5,592	2,829	8,837	203
EU (Non-Greek) (12/13 reporting)	n/a	2,654	2,391	5,190	n/a
United States (5/5 reporting)	n/a	1,994	503	2,785	n/a
Other Foreign (5/5) reporting)	n/a	375	254	668	n/a
Total of all Banks	n/a	56,407	50,281	111,243	n/a

[1] Foreign banks are not required to disclose operating results. However, by all accounts, the foreign banks are profitable.

GREECE

SECURITIES

SUMMARY

The Greek securities industry consists primarily of trade in equities and government obligations. The corporate bond market is extremely small. There is no legal framework for trading floating rate instruments, derivative instruments (options, swaps, futures, and forward rate agreements), or commodity futures at the present, although the authorities have expressed an intent to develop these markets sometime in the future. Consequently, the Athens Stock Exchange is comparatively small, and share prices are often subject to considerable volatility.

Trade in government instruments, whose yields are tax free, dominate the industry, with high real interest rates on government paper often crowding out investor interest in taxable private sector securities. Gross government borrowing is expected to be roughly $22 billion in 1994, or 23 percent of projected GDP. The recent difficulty of placing such a large amount of debt has resulted in more than one-third of Greek government borrowing being done in foreign-currency-linked obligations.

The government has announced the sale of minority equity positions in a number of public enterprises. The first 100 percent state-owned company involved will be the Public Telephone Company, OTE. The sale of 25 percent of OTE shares is expected to raise roughly $1 billion. Since such a large offering cannot be readily absorbed by domestic investors through the Athens Stock Exchange, 70 percent of the offering will be underwritten and sold offshore.

Greece has liberalized its financial markets over the past few years, bringing them closer in line with European Union (EU) standards. The freeing of short-term capital movements in mid-1994 was the most recent step in the liberalization of the Greek financial markets. However, Greece has not yet introduced floating rate instruments, derivative instruments (options, swaps, futures and forward rate agreements on interest rate, currency, and stock products) or commodity futures. Additionally, the level of infrastructure services to support the securities industry, such as custodial services for equity holders, have not been established.

Of the 58 companies in the securities industry, only a handful are large, well-established firms. The remainder are small, newly formed companies, or even individuals registered as brokers. One American securities company operates a branch in Greece, and it sells only offshore products to resident investors. One other American firm has a correspondent office in Greece, which offers equities and investment products offered by the American parent to Greek residents.

DESCRIPTION OF THE MARKET

Government Securities

Greece's government budget deficits, officially projected at 13 percent of GDP for 1994, create a large public sector borrowing requirement. Gross government borrowing is projected to be approximately $22 billion in 1994, more than one-third of which will be raised through the sale of foreign currency-linked obligations.

First issuance of government obligations are sold to retail customers almost exclusively through domestic and foreign commercial banks operating in Greece, with less than 1 percent sold through brokerage firms. Government obligations are priced under a non-auction system administered by the Ministry of Finance. The Ministry sets the prices of Treasury bills and bonds, and often directs the state-controlled commercial banks to purchase the securities at these set prices. The government thereby coordinates the direct sale of Treasury obligations to cover its needs. The commercial banks resell a portion of their government securities portfolio, for a commission, directly to retail customers, through repurchase agreements (repos), or through mutual funds.

The Greek government has recently entered into discussions with the large, state-controlled commercial banks to establish a secondary market on an auction basis. Under this system, the state-controlled banks would act as primary dealers and auction government paper to third party investors. The details of this system, which was used to a limited degree in the past, are not yet available.

The Athens Stock Exchange

By EU standards, Greece's equity market is small. Roughly two hundred companies are listed on the Athens Stock Exchange (ASE), but the 20 largest firms account for about two-thirds of the market's total value. In 1993, the initial public offering of 10 companies and other capital increases raised 100 billion Drachmas ($425 million) in new equity capital. In the first seven months of 1994, 27 new companies were listed on the ASE and another 31 companies increased equity capital, raising a total of over 165 billion Drachmas ($702 million).

Very few corporate bonds have been listed on the Athens Stock Exchange. Investor demand for government obligations, which yield high, tax-free returns, has greatly inhibited the growth of the corporate bond market in Greece. (The average 12-month Treasury bill rate for 1994 will be about 20 percent, tax-free.)

ASE trading volume and prices have been subject to considerable volatility. Average daily trading volume ranges from $10 to $20 million, spiking to $80 million during the January 1994 bull market. The general stock price index (1980 = 100) crested at 1521 in July 1991, but

closed the year at 810. The index fell to 671 at the end of 1992, but recovered 25 percent of its value in 1993. A bull market in early 1994 pushed the index up to the 1200 level, but the market has since retreated to the 850 range.

Both the Athens Stock Exchange and the government bond market operate in a conservative and labor-intensive way. There is no margin buying. Settlement is in cash, and the buyer takes physical possession of the bond or stock certificate. In the case of government bonds, there is an eight- to ten-month backlog on the delivery of certificates. Custodial systems, wherein a purchaser maintains a computerized ledger account, have not been established.

The Athens Stock Exchange has undergone liberalization and expansion since the promulgation of the 1988 Stock Exchange Law, which permitted the establishment and operation of corporate brokers as full members of the ASE. Previously, exchange membership had been restricted to individuals only. As a result, the number of seats on the exchange has expanded from 15 to 60, with brokerage firms owned by banks and other financial companies holding far more seats than individual brokers.

The 1988 Stock Exchange Law also established a central securities depository, and a "parallel" market for those companies unable to meet the requirements of the initial public offering on the ASE (insufficient capital; few years of profitable operation). By September 1994, 10 companies were listed on this "parallel" market.

In 1992, the Athens Stock Exchange introduced a modern electronic trading system, and the government began implementing legislation to bring Exchange operations in line with EU Directives. All directives issued through 1992 have been incorporated into Greek law. Directive 26/93 on investment services will soon become Greek law.

Due to recent foreign investor interest in emerging markets, demand for shares listed on the Athens Stock Exchange has increased. Daily volume is expected to rise as a result of the expanding foreign demand for Greek equities, particularly as the Greek government sells equity stakes in state-owned utility companies. Foreign equity participation currently accounts for about 20 percent of daily ASE transactions.

There are currently 52 brokerage firms and six individual registered brokers owning seats on the Athens Stock Exchange. Their activities principally involve trading stocks and managing mutual funds. Over 80 percent of these firms were founded within the last five years on the expectation that EU-mandated liberalization and deregulation requirements of member countries' financial markets would invigorate the growth of Greece's capital markets. Only 7 percent of these firms have a net worth over $8 million.

Regulation

The Athens Stock Exchange, while self-managing, is not considered to be a self-regulatory organization. Its supervisory department is staffed by officials from the Ministry of National Economy.

The exchange is also supervised by the Capital Market Committee (CMC), a regulatory body under the aegis of the Ministry of National Economy. The seven members of the CMC are appointed by the Ministry and serve six-year terms. Committee member appointments are staggered annually. The CMC's function is to provide information to investors and to enforce Greece's securities laws.

Three types of securities firms are permitted to operate on the Athens Stock Exchange. Minimum capital requirements vary depending on the activity authorized for each firm and are subject to increase:

- Brokers acting only on behalf of clients:
  100 million drachmas ($425,000)

- Broker-dealers:
  200 million drachmas ($850,000)

- Underwriters and broker-dealers:
  1 billion drachmas ($4.25 million)

In addition to depositing the required minimum capital with a Greek bank, a brokerage firm must fulfill the following requirements: incorporate in Greece with the approval of the Ministry of Trade, be licensed by the Capital Market Committee, be listed in the Corporate Register, publish the articles of incorporation in the Government Gazette, and employ at least one Greek broker licensed to trade on the Athens Stock Exchange.

Mutual Funds

As of December 1993, 71 mutual funds are operating in Greece, with net assets of 874 billion drachmas ($3.8 billion).

Under the Law 1969/91, two-fifths of the share capital of a mutual fund management company must belong to a corporation with a minimum paid in capital of 500 million drachmas, or the equivalent in foreign exchange. The law restricts ownership to a maximum of 50 percent for any partner in a mutual fund management company. Two or more partners must exist.

Foreign banks and securities firms are bound by the same rules.

Pension Funds

All pension funds in Greece are controlled by the state.

U.S. PRESENCE IN THE MARKET

Merrill Lynch has operated a branch in Greece for 27 years. It is the only U.S. securities firm with a branch office in Greece. Several other American firms had local branches in the past, but closed them.

Merrill Lynch provides Greek residents access to international financial markets, brokering American and other international financial securities. Merrill Lynch does not operate in the Greek equity or bond markets. The firm recently announced plans to convert its securities branch (Merrill Lynch, New York) into a branch of its London-based international bank. (See European Union chapter for discussion of EU directives.)

Paine Webber is the only securities firm with a correspondent office in Athens, with a Greek broker. Under this relationship, Greek individuals with corporations may purchase equities or investment products offered by the American brokerage house through its Greek correspondent. Other U.S. firms, such as Prescott, have agents in Greece who provide similar services.

Citibank brokers local and offshore funds directly to Greek residents. American Express Bank brokers only offshore mutual funds to Greek residents. In addition, all four American banks in Greece trade Greek government securities for their own portfolios.

TREATMENT OF U.S. INSTITUTIONS

In general, there are no legal constraints on foreign, non-EU, ownership of subsidiary companies in Greece, other than those applying equally to Greek and EU subsidiaries. A U.S. brokerage firm may operate in Greece and own a seat on the exchange, if it is in compliance with minimum capital and other requirements. At this time, however, no U.S. firm has chosen to do so.

There are no legal barriers regarding form of entry of foreign firms into the Greek securities market, nor is there a limit on percentage ownership of a locally incorporated firm. However, direct branches of foreign securities firms are not allowed to operate on the Athens Stock Exchange. The absence of U.S. firms in Greece is ostensibly due to a lack of commercial opportunity and the relatively underdeveloped state of Greece's capital markets.

There are no specific restrictions on domestic firms' access to offshore markets as underwriters. Morgan Guaranty Trust Company of New York was recently involved in managing an issue of ADRs on behalf of a Greek bank.

On May 16, 1994, the Greek government lifted all restrictions on short-term capital movements. This theoretically removed all barriers to investment by foreigners in Greek stocks and bonds. While Greek residents' access to offshore financial markets was also liberalized, the process remains cumbersome. Banks or financial institution executing the offshore transaction on behalf of a Greek resident must "monitor" the investment. Upon maturity or liquidation, the funds must be returned to Greece and converted back into drachmas. Only after "reconverting" the investment into local currency can the funds be used once again for investment offshore.

Merrill Lynch, the only American company operating a securities branch in Greece, does not have any significant complaints or problems with regulation by the Greek government. In general, Merrill Lynch feels that it is treated equally with Greek firms, and that it is able to implement its business plans without undue interference by the government.

ITALY

SECURITIES

SUMMARY

The Italian securities market has two major parts, a sizeable government securities market and a much smaller private securities market trading equity and fixed-rate debt instruments. The government securities market is dominated by banking institutions that act as underwriters and brokers as well as dealers in the secondary market. The government has made a number of changes in the operation of the market because of the size of the public debt, the need to lengthen the maturity of the debt, and the desire to expand the market beyond primarily Italian households to domestic and foreign intermediaries.

By contrast, the market for equities has remained small and is relatively undeveloped, although it is the fourth largest in the European Union. A series of recently passed laws, designed to modernize the market and its regulatory structure in preparation for the European single market, should help to transform the market. The goals of these laws are to increase the size of the equity market, increase market efficiency, and attract new investors and companies. Recent laws have created new security intermediation companies (SIMs) and institutional investors, such as closed-end funds and pension funds. SIMS are authorized to carry out a range of financial activities, including trading, brokerage, underwriting, fund management, and financial consulting. In addition, the government's privatization program should help develop the market.

There have been major improvements in the openness of Italy's financial markets. However, the requirement that all security transactions must be carried out by SIMs adversely affects U.S. and other foreign financial institutions because a U.S. firm must create, at sizeable additional cost, a new subsidiary registered and located in Italy. SIMs face minimum capital requirements based on the scope of their activities. There also are requirements regarding directors' experience and honesty, and limits on interaction with clients. "Financial promoters" can be of any nationality, but they must be domiciled in Italy and home-based in an EU country.

The European Commission has filed an official complaint against Italy, arguing that the SIM law's subsidiary requirement is an unacceptable barrier to freedom of establishment and free provision of services in the EU. The Commission has challenged the SIM law as a violation of the EU's Treaty of Rome and it will clearly be in violation of the EU's Investment Services Directive (ISD), which will enter into force on January 1, 1996. Similarly, at the OECD, questions have been raised about the consistency of the requirements with members' obligations.

DESCRIPTION OF THE MARKET

Type of Instruments

The public sector has dominated Italy's securities market for years. The necessity of financing Italy's large public debt, which was 119 percent of GDP at end-1993, the high yields on government securities, and the liquidity of the market have made it difficult for the private sector and equity market to compete. The government issues a variety of securities, from three-month bills to medium-term floating-rate certificates and long-term, fixed-rate bonds. These securities are denominated in lire and ECU. The Treasury also issues bonds denominated in various foreign currencies, such as dollars, Deutschemarks, and yen. These are traded outside of Italy in New York, London, Paris, and Tokyo.

In recent years, the Treasury has been trying to lengthen the maturity of the debt. The average maturity of Treasury debt was three years at end-1993, compared to two years and nine months at end-1992. Medium- and long-term Treasury securities account for 53 percent of total debt. Treasury instruments with a maturity of one year or less account for 22 percent. The remainder is postal and special credit institution debt.

Italian households hold the majority of Treasury debt, 48 percent at end-1993. Italian banks and insurance companies own 24 percent, and nonfinancial firms own 8 percent of the debt. The Bank of Italy owns 10 percent, and foreigners own 8 percent. Most Treasury securities are bearer instruments and can be easily negotiated. Since 1987, interest on Treasury securities has been subject to a withholding tax of 12.5 percent. Interest income of individuals is not subject to further taxation. A procedure to reimburse the withholding tax to foreign investors within 30 days from coupon payment was introduced in March 1994.

Many large public sector enterprises issue fixed-rate bonds. Some corporations issue ordinary and convertible bonds, but this market is limited because of the predominance of the government securities market.

There are three categories of shares traded on Italian exchanges. Ordinary shares are registered, participate in the distribution of profits, and have a right to vote in company shareholder meetings. Preferred shares are registered and have a preference over ordinary shares in the distribution of profits. However, they only have a right to vote in extraordinary cases, such as approving changes in corporate statutes (bylaws). Savings shares were introduced in 1974 and can be issued only by limited companies, whose ordinary shares are listed on the Stock Exchange. They are normally issued in bearer form. They take preference over ordinary and preferred shares in the distribution of profits, and this right is cumulative up to a maximum of three years. They also have a right to a dividend which is at least two percentage points superior to that distributed to ordinary shareholders. However, these shares carry no right to vote. Savings shares have had a limited appeal and their future is uncertain. In addition to the

three types of share described in this paragraph, stock warrants also are issued. Corporate bonds are negligible.

Size of Market

Government securities accounted for 81 percent of net security issues in 1993. Stock issues accounted for 7 percent. Securities issued by special credit institutions and state-owned companies accounted for the remaining 12 percent. By comparison, in 1989 government securities accounted for 79 percent of net security issues, while equity shares accounted for 14 percent. The remaining 7 percent was accounted for by special credit institutions and state-owned companies.

Although the Italian government bond market is the third largest in the world, totalling 1,472 trillion lire ($864 billion at end-1993), the equity market is small compared with other major world markets and does not reflect the size of the Italian economy. The Italian equity market is smaller in terms of capitalization, the number of companies listed, and turnover than the German and French markets. The Italian market has 222 listed companies compared to 665 on German exchanges and 677 on the Paris exchange. There are four foreign companies listed on the Italian exchange, 229 in Frankfurt, and 205 in Paris. The average capitalization of domestic companies as a percentage of GDP in 1992 was 15 percent in Italy, 23 percent in Frankfurt, and 37.6 percent in Paris.

Nevertheless, the Italian equities market has grown in the last 10 years. The number of listed companies has increased from 138 in 1982 to 222 in 1993. Market capitalization has increased from 27 trillion lire ($20 billion) in 1982 to 223 trillion lire ($142 billion) in 1993. Market volume has increased from 1.6 trillion lire ($1.2 billion) in 1982 to 103 trillion lire ($65 billion) in 1992.

Although the Italian Treasury has accounted for much of the increase in total securities since 1980, equities nevertheless account for an important portion of the private sector's financial assets. Holdings of Treasury securities accounted for 14 percent of private financial assets at end-1980, and increased to 25 percent at end-1993. Holdings of domestic equities increased from 10 percent of private financial assets at end-1980 to 21 percent at end-1993. The portion accounted for by claims on financial institutions (bank accounts) declined from 58 percent to 30 percent over this period. At end-1993, holdings of foreign stocks and bonds accounted for 3 percent of private financial assets compared to 0.4 percent in 1980.

Location of Markets

Until 1993, the Italian stock market was made up of 10 stock exchanges (Bologna, Florence, Genoa, Milan, Naples, Palermo, Rome, Trieste, Turin, and Venice). The Milan exchange was by far the most important. It accounted for most of the activities in government securities and bonds, and 90 percent of equity activities. Since February 1993, the 10 exchanges are no longer independent of each other. They have been linked by a continuous computerized trading system into one national exchange. The passage of the SIM law in 1991 has moved the majority of trading back onto the exchanges.

Market Participants

In 1992, SIMs (stock intermediation companies) began to operate on the Italian exchange. Stockbrokers can continue trading on exchanges until their number falls to zero by attrition. SIMs can perform a wide variety of investment related functions such as placing securities, managing assets invested in securities, and providing advisory services.

Credit institutions may also provide investment services, subject to authorization by the Bank of Italy, except for trading of securities (other than government and government-guaranteed securities) on the stock exchange and the secondary markets.

Before the SIM law, stockbrokers were required to be Italian citizens and to act in a personal capacity. Thus, stockbrokers had a monopoly on transactions executed on exchange floors. Commission agents and banks had desks just off the trading floor for relaying orders. The banks and commission agents could make over-the-counter transactions without going through stockbrokers.

Supervisory Authorities

The SIM law, passed in January 1991, restructured the Italian stock market (comprised of the 10 exchanges) and reduced the management and regulatory structure to three bodies: CONSOB, the Bank of Italy, and the Italian Stock Exchange Council. The responsibility for control and regulation of the Italian stock market is assigned to both CONSOB and the Bank of Italy (the central bank). CONSOB is the acronym for the National Commission for Corporations and the Stock Exchange (Commissione Nazionale per le Societa e la Borsa). The Commission is responsible for the surveillance of market activities, operators, and developments and the full disclosure of information to the public. The Chairman and four members of CONSOB are appointed by the President of the Republic on the advice of the Council of Ministers. They hold office for five years and may be reappointed only once. The Bank of Italy (BOI) is responsible for supervising the financial soundness of not only credit institutions, but also of the new security companies (SIMs).

The Italian Stock Exchange Council (Consiglio di Borsa) was created by the 1991 SIM law and has modified substantially the organization of the Italian stock market. It has national jurisdiction and full responsibility for the running, management, and promotion of the Italian stock exchange. It began operations in February 1993, replacing the myriad of bodies previously involved in the running of the 10 regional stock exchanges. The Council has developed a program for the reorganization and modernization of the Italian market, with primary objectives of financial transparency and efficiency. The Council plans to equip the Italian market with the technical support, instruments, and information necessary to develop and compete with other major international markets. The Council has been appointed by decree of the Minister of the Treasury for three years. Of the 14 members, seven represent SIMs, two represent banks, two represent listed firms, and three represent CONSOB, the BOI, and the Chambers of Commerce, respectively.

Changes Since 1990

The Italian securities market has undergone major reform. The key changes are modifications to the regulatory structure of the exchange and the modernization of the trading system to meet international standards and prepare for the EU single market. The following table presents the main changes of the last four years in chronological order:

Chronology of Legal Changes

Amato Banking Law	July 1990
SIM Law	January 1991
Capital Gains Tax	March 1991
Insider Trading Law	March 1991
National Guarantee Fund	September 1991
Computerized Equity Trading	November 1991
Off-market and Block Transactions	November 1991
Law on Takeover Bids	February 1992
Law Authorizing Government Securities Futures Market	February 1992
Clearing and Guarantee Fund	March 1992
Privatization Law	December 1992
Private Pension Funds Approved	April 1993
Closed-end Funds Approved	August 1993
Closed-end Real Estate Fund Approved	January 1994

The Amato Banking Law, passed in July 1990, was intended to modernize and restructure state-owned banks and government special credit institutions. The law changed these banks into joint stock companies, making profitability their main objective. Since Italian banks were smaller than competing foreign banks, the law provided incentives for mergers. The overall goal of the law was to increase operating efficiency so that Italian banks could compete

internationally and provide better, more efficient, and cheaper financial services domestically. Banks can engage in certain types of securities activities.

The Securities Investment Law, the SIM law, passed in January 1991, completely redesigned the structure of financial intermediation in the Italian securities market. It created SIMs to replace traditional stockbrokers, who, while still allowed to transact security business, will disappear through attrition. SIMs are authorized to carry out a range of financial activities, including trading, brokerage, underwriting, fund management, and financial consulting. The law broadly followed the European Union (EU) Investment and Capital Adequacy Directives. A SIM must be incorporated as a joint stock company or as a limited partnership under Italian law. A SIM must be located in Italy, it must disclose the activities to be carried out, it must meet minimum capital requirements based on the activities of the SIM, and it must be registered with CONSOB in order to operate on an Italian exchange. There are no restrictions on foreign ownership of SIMs, but there are difficulties for foreign financial institutions, problems that will be discussed in the section on the Treatment of U.S. Financial Institutions.

SIMs are required to execute all transactions on exchanges, unless specifically requested by a client not to do so. When they trade off the exchange, they must inform CONSOB of the transaction. Block transactions may be executed off market, but must be reported within 90 seconds. The goal is to concentrate transactions on exchanges and maximize transparency.

Transactions in government securities are excluded from the provisions of the SIM law. The SIM law gave CONSOB the authority to establish a single, national exchange and the operating rules for the exchange. To carry out the full range of financial activities, a SIM must be capitalized at three billion lire ($1.9 million).

The SIM law also includes provisions to protect the interest of investors. The Bank of Italy sets capital ratios and supervises capital adequacy. CONSOB regulates and supervises the activities of SIMs to ensure compliance with market rules and to prevent conflicts of interest with clients.

By end-1993, about 300 SIMs were registered with CONSOB, 20 percent of which were controlled by banks. About 25 SIMs are subsidiaries of foreign banks. Around 35 SIMs were authorized to carry out all activities permitted by law and 170 were authorized to act as brokers and dealers.

A complex and confusing capital gains tax was introduced in March 1991 when the market was undergoing a number of changes and was in a slump because of the weak economy. The tax was suspended in October 1992. In May 1994, the tax on capital gains realized by individuals on the sale of securities listed in official markets was suspended indefinitely.

The insider trading law was passed in May 1991. The law refers to all securities admitted to a regulated market in Italy or elsewhere in the EU and prohibits transactions in securities on the

basis of confidential information. Punishments are specified. The law allows CONSOB to share information on suspected violations with other countries.

A continuous computerized trading system for equities began in November 1991. By mid-April 1994, all securities were traded on this system. The change from an open-outcry auction market to a continuous computerized market has made the 10 regional Italian exchanges into one national exchange and has raised Italian market efficiency to world standards. The Italian market is now transparent and information is disseminated rapidly.

In November 1991, CONSOB introduced disclosure rules for off-exchange and block trading. Very large transactions can be executed off the exchange. The minimum size of blocks is determined for each share according to the daily average trading volume in the previous six months. Rules have been imposed on intermediaries in this market to guarantee information flow and protect investors' interests. All transactions must be reported to the authorities, via terminal, within 90 seconds of execution. The information is transmitted to the market after 60 minutes. Trading volume on this market is about 12 percent of all transactions.

The Law on Takeover Bids, passed in February 1992, set rules for public offers for sale (offerte pubbliche de vendita, OPV) and public purchase offers (offerte pubbliche di acquisto, OPA). Such offers are considered valid only if they abide by all the conditions set out by the law and by CONSOB. In the case of OPAs, the law prescribes the conditions under which the offer is compulsory. Both compulsory and voluntary OPAs must be carried out in the same way. In order to avoid speculation, both the offer and the acceptances of the offer are irrevocable. An OPA must be launched should someone intend to acquire the controlling interest in a listed company. The OPA allows minority shareholders to participate in the premium paid for the controlling interest. The protection of minority shareholders is intended to aid in developing the Italian market.

Also in February 1992, a decree law authorized the creation of the Mercato Italiano dei Futures (MIF), a futures market in government securities. The law establishes who can operate in the market and defines capitalization requirements for market participants. There are only a few contracts currently traded. The market is directed by a management committee with self-regulatory powers.

As required in the SIM law, a ministerial decree was approved in September 1991 establishing a National Guarantee Fund to protect the interests of investors. The fund is financed by fees assessed member organizations. Assets are invested in government and government guaranteed securities. A maximum of 40 percent of the fund's resources and a maximum of 25 percent of each investor's loss can be covered in case a SIM declares bankruptcy.

The privatization law passed in December 1992 provides for the largest sale of state-owned assets within the European Union. At end-1993, state companies held assets valued at 80 trillion

lire ($50 billion). The government hopes to raise 30 trillion lire ($18 billion) from 1995 to 1997. IRI, the largest state enterprise, hopes to raise 24 trillion ($16 billion) to reduce its large debt. The objective of privatization is not only to raise money, but also to increase the competitiveness of industry, improve the efficiency of domestic capital markets, inject new capital into the system, and attract new companies to the market.

By mid-1994, two major commercial banks (Credito Italiano and Commerciale Italiano) and five companies had been privatized. A medium-term bank (IMI) and an insurance firm (INA) had been partially privatized. The sales have raised 13 trillion lire ($8 billion).

The law allowing for the creation of pension funds was passed in April 1993, 11 years after the first legislation on pension funds was drafted. Pension funds have been slow to begin operations because of delays in publishing rules and unfavorable tax treatment. Although of limited impact to date, these funds should pump new funds to the undernourished equities markets as fund managers look for good investments. The funds must be authorized by the Ministers of Labor and Social Security. The aim of the law is to provide a high level of pension coverage for workers to supplement the compulsory national pension system.

The law allowing for the creation of closed-end funds was approved in July 1993. The law creates a new category of institutional investors who will be able to invest funds directly into small- and medium-sized companies. This measure will help to satisfy the financial needs of this large sector of Italian industry. The funds must be authorized by the Ministry of the Treasury and the Bank of Italy. The minimum capital requirement is five billion lire ($3.2 million) for management companies dealing with only closed-end funds and seven billion for management companies that intend to manage both closed and open-ended funds. Fund managers must hold at least 5 percent of the fund. Subscriptions to the fund are made in one single offer. The funds must ask CONSOB to be listed on an officially regulated market within three years of being established, unless all subscribers are institutional investors. A 1992 study identified over 1,800 Italian companies that meet the requirements to be listed on the Italian stock exchange. These companies are traditionally closely held, well managed family concerns. It is hoped that closed-end funds will be able to invest in these companies, which may then become accustomed to outside investors and may eventually list themselves on the Italian exchange. A January 1994 law allows the creation of closed-end real estate funds.

Exchange Controls

There are no restrictions on Italian residents investing abroad, or on foreigners investing in Italy (except for a few strategic industries). All exchange controls were abolished in May 1990 as part of the movement toward a unified European market. The liberalization has made Italy, because of its high personal savings rate, an important investor base for foreign financial institutions to tap.

U.S. PRESENCE IN THE MARKET

U.S. commercial banks and securities firms have been established in Italy for decades. Before passage of the SIM law, foreign stockbrokers were limited to giving advice because Italian stock exchanges barred foreign and Italian firms from operating on the exchanges and only allowed Italian individuals to be brokers. Under the SIM law, foreign commercial banks and foreign securities firms can create SIMs in Italy. They can participate in the full line of security operations, and can compete on the same basis as other SIMs. Six U.S. investment firms and banks have established SIMS to date.

The role of foreign banks in Italy has continued to change in recent years. At end-1988, there were 38 branches of foreign banks in Italy with 62 outlets. At end-1992, there were 38 branches — the few that had closed were replaced by other banks — with 369 outlets. The number of branches of U.S. banks peaked at 14 in 1984 and declined to eight in 1993. Foreign banks' share of total lending and total assets has increased in recent years; the U.S. share of both has been flat. Deutsche Bank purchased Banca d'America e d'Italia in 1988 (149 outlets) and Banca Popolare di Lecco in 1993 (85 outlets). Crédit Lyonnais purchased Credito Bergamasco in 1989.

Thus, the German and French presence has increased in comparison with U.S. banks. U.S. banks and most foreign banks are involved in wholesale, not retail banking. French and German banks are involved in both retail and wholesale banking operations.

A few U.S. investment banks also operate in Italy. Previously, they were limited to advisory services and soliciting business for other markets rather than undertaking operations in Italy's securities market. Most have created SIMs to provide a wide range of services and carry out security transactions.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign commercial banks, investment banks, security firms, and individuals wishing to operate in the Italian securities market or deal with Italian clients can do so only through the creation of a SIM, a stock intermediation company. A SIM must be incorporated in Italy under Italian law and must be located in Italy. The firm must have the minimum capital fixed by the Bank of Italy, which ranges, according to the activities performed, from 600 million lire ($382,000) to three billion lire ($1.9 million). A SIM must be authorized by CONSOB. There are no restrictions on holding an interest in a SIM. Natural or legal persons and financial and industrial companies, whether Italian or foreign, may own interests.

The SIM law adversely affects U.S. and other foreign financial institutions in Italian capital markets, which had been providing services into Italy on a cross-border basis. A U.S. firm must create a new entity registered and located in Italy. It is costly to do so. There are minimum capital requirements based on the range of a SIM's activities. There are requirements regarding directors' experience and honesty.

EU members have filed an official complaint against Italy arguing that the SIM law is an unacceptable barrier to freedom of establishment and free provision of services in the EU. The European Commission has challenged the SIM law as a violation of the EU's Treaty of Rome and it will be clearly in violation of the EU's Investment Services Directive (ISD), which will enter into force on January 1, 1996.[1] In January 1994, three years after the Commission's first letter of complaint to the Italian government and six months after Italy had agreed to send an amendment to the SIM law to Parliament, the European Commission opened a case in the European Court of Justice against Italy for failing to change discriminatory security market rules. The case is in process.

When Italy implements the ISD, EU-based subsidiaries of U.S. firms outside of Italy will have the same access to the Italian market as other EU firms.

Exchange Rates

Average 1980: $1 = 856.4 lire
Average 1982: $1 = 1,352.6 lire
Average 1990: $1 = 1,198.4 lire
Average 1991: $1 = 1,241.6 lire
Average 1992: $1 = 1,232.3 lire
Average 1993: $1 = 1,572.7 lire

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[1]According to the Italian government, the ISD permits Italy to continue to restrict access by banks to its stock market until January 1, 1997. Therefore, Italy has until January 1, 1997 to amend the SIMs law to allow banks to operate on the Italian exchange and to act as broker/dealers for commercial paper. By January 1, 1996, when the ISD takes effect, Italy must amend the SIMs law to allow EU non-bank financial intermediaries to operate on the Italian exchange under the "single passport" on the basis of mutual recognition.

PORTUGAL

BANKING

SUMMARY

After Portugal's accession to the European Community in 1986, the Portuguese financial sector underwent significant reform. Most of the once- nationalized financial system is now in private hands. The number of banks has doubled over the past 10 years. Foreign investment has played an important role in this transformation. The financial sector was the largest recipient of foreign investment in the 1986-1993 period. The opening of the financial sector has led to increased competition and specialization. Margins and fees, however, still remain high by EU standards.

The elimination of all barriers to capital movements and the escudo's incorporation in the Exchange Rate Mechanism of the European monetary system in 1992 is expected to hasten the domestic financial system's convergence to EU norms. Portugal's adoption of the EU's Second Banking Directive in 1993 will also aid convergence.

Foreign banks face no legal constraints on establishment in Portugal as either branches or as subsidiaries. However, prudential limits for foreign branches are based on locally held capital rather than that of the parent. U.S. banks have elected to operate as majority-owned subsidiaries and to concentrate their activities on various wholesale market niches. U.S. banks are often leaders in these market segments. U.S. presence in the retail end of the financial sector is modest.

Portugal limits foreign participation in acquisitions of state-owned banks being privatized. The authorities set 25 percent foreign ownership as a guideline, but have the discretion to specify a higher or lower percentage on a case-by-case basis.

DESCRIPTION OF THE MARKET

Nationalization

In the aftermath of the 1974 revolution, much of the Portuguese economy, including the financial sector, was nationalized. Interest rate ceilings were imposed, as were credit ceilings on the productive sector. Loans were often granted for political reasons, and banks were often seen as employment agencies. Not surprisingly, the financial sector in this period was uncompetitive and did not allocate credit efficiently.

Privatization

In 1984, the government took its first step to liberalize the financial sector when it allowed three private banks to begin operations. One of these three private banks was Manufacturers Hanover Trust Company (MHT has since been merged into Chemical Bank).

When Portugal joined the European Community in 1986, the pace of liberalization and reform in the financial sector accelerated. Indeed, the financial sector has undergone a more rapid transformation than most sectors of the economy. The number of banks operating in Portugal more than doubled between 1983 and mid-1994, increasing from 16 to 43. The number of foreign banks operating increased from an initial three in 1984 to 15 today.
A major change in the ownership structure of the financial system was put into motion with the amendment of the Constitution in 1989 allowing for complete private ownership of national banks. Between 1990 and 1993, seven banks were partially or fully privatized. This resulted in a dramatic change in market shares as measured by total assets. The financial sector shifted from 71 percent public ownership in 1990 to approximately 66 percent private ownership in June 1993.

In addition to the privatization of several large banks, the private sector gained market share at the expense of public banks due to lower costs and stronger capitalization. The government of Portugal plans to sell its remaining 25 percent position in the Banco Portuguese Atlantico (BPA) and to privatize the Banco Pinto Sotto Mayor, the country's seventh largest bank in terms of assets. However, when the privatization program is completed, the government will still retain a substantial presence in the financial sector through its ownership of the Caixa Geral De Depositos (CGD) and Banco De Fomento Exterior (BFE) groups.

Market Share of Total Assets
(percent)

	June 1991	June 1994
Public Banks	71.3	45.5
National Private Banks	23.1	38.0
Foreign Banks	5.7	7.5
Total	100.0	100.0

ERM

In 1991, the central bank eliminated the use of credit ceilings in favor of an open market operation for the implementation of monetary policy. Also in 1991, administered interest rates on all banking operations were abolished. The shift to indirect implementation of monetary

policy was followed by the progressive removal of capital controls in 1992, including the escudo joining the ERM.

Government authorities had expected that ERM membership would force Portugal's high domestic interest rates to converge rapidly toward EU norms. However, real interest rates have not come down as quickly as expected. The average real interest rate on 180 day loans was 9.4 percent in 1992; real rates rose to 12.7 percent in 1993.

Several explanations for this unexpected interest rate behavior have been advanced by local financial experts. The turbulence that buffeted the ERM in 1992-1993 discouraged companies from seeking foreign currency denominated financing. Portugal's industry is dominated by small and medium-sized family companies, which often find it difficult to negotiate favorable loan terms with banks. Bankers maintain that these family operations are often unwilling to provide accurate information on their companies' financial condition.

Foreign Investment

Foreign investment in the financial sector was intensive in the 1986-1993 period, averaging 1.5 percent of GDP.

Entry strategies varied. Some banks opted to buy large minority shares in existing private banks. Others opted to participate in the privatization of banks. Still others started retail operations from scratch. The privatization law limits foreign ownership of individual state-owned financial institutions being privatized to 25 percent of total capital. Spanish banks pursuing an Iberian single market strategy have been particularly aggressive in buying significant stakes in privatizing banks such as Banco Totta E Acore (BTA) and Banco Comercio e Industrio (BCI). Thus, foreign presence in the financial sector is actually greater than the 7 percent noted in the accompanying table.

Between 1990-1992, foreign banks wishing to buy stakes in privatized banks, or to increase their existing branch network, had to pay a fee of 900 million escudos (about $7 million) that was not imposed on domestic banks. This discriminatory entry feature was abolished by the new banking law, which transposed into national legislation the EU's Second Banking Directive.

Recent Trends

The new banking law, which entered into effect in January 1993, established the principle of a universal banking system. The law also terminated the Treasury's overdraft facility at the central bank. In addition, the law established the framework for a deposit insurance fund in line with the EU Deposit Insurance Directive.

A legacy of nationalization is that the financial sector is burdened with a high cost structure. Measured by number of employees per branch, assets per employee, or by overall operating costs, the operating efficiency of Portugal's financial sector is below the EU average.

Increased competition has taken its toll on financial margins. The average financial net interest margin for Portuguese banks was reduced from 8 percent in June 1991 to 3.79 percent in June 1993. Bankers expect margins to fall to about 3 percent in 1994 and then stabilize. Margins have been further pressured by reduced demand and a rise in nonperforming loans reflecting the 1993 recession.

Concentration levels have increased noticeably over the past few years. In June 1993, the top five banking groups held a commanding 66 percent of the market, up from 53 percent only three years before. A strong battle for market share is being waged. Observers feel that many smaller banks will not be able to survive the reduction in net interest margins and will be absorbed by large banking groups.

Lending, Bad Loans, and Capital Adequacy

New loans fell from a 17.5 percent annual increase in 1992 to a 13.6 percent increase in June 1993. Bad debts increased from 560 billion escudos, or 6 percent of total loans, to an estimated 650 billion escudos, or 8 percent of outstanding loans.

The capital solvency ratio (equity capital and reserves/total assets) improved from 7.9 percent in 1989 to 9.7 percent in June 1993. According to the data, assets totalled 21.2 trillion escudos ($13.2 billion), or 14.7 percent of 1993 GDP.

Distribution of Financial Assets
(June 1993)

	Amount (trillions of escudos)	Percent of Total
Cash and Deposits	2.5	11.7
Loans to Clients	11.9	56.5
Stocks and Bonds	4.6	22.0
Tangible Investment	0.6	2.9
Other Applications	1.5	6.9
Total	21.1	100.0

Distribution of Financial Liabilities
(June 1993)

	Amount ((trillions of escudos)	Percent of total
Deposits by Clients	12.9	61.1
Amounts Due to Other Financial Entities	4.6	21.8
Debts Represented by Securities	0.5	2.4
Other Liabilities	1.1	5.2
Total Liabilities	19.1	90.5
Shareholders Equity	2.0	9.5
Total	21.1	100.0

ATMs

There are 3,000 ATMs in Portugal that are operated by an interbank service society (SIBS) formed by 31 banks. SIBS estimates that of 400 million banking operations per year, 140 million operations are carried out electronically. There are 4.8 million ATM cards in circulation.

Deposit Insurance

The government is planning to establish a deposit insurance fund by the end of 1994. This will be drafted to conform with the EU's directive on deposit guarantee programs. Funds freed by the planned reduction in bank reserve requirements may be used in part to support initial capitalization of the fund. Final details were not available as of mid-October 1994 on the modalities of bank contributions to the fund. Apparently, all institutions with deposit liabilities will participate and pay a fee based on the level of deposits.

U.S. PRESENCE IN THE MARKET

The U.S. banking presence in Portugal is modest. The two U.S. bank subsidiaries currently in Portugal account for about two-thirds of the total profits of the 15 foreign banks in the country. The two banks — Chemical Bank and Citibank — engage in both retail and wholesale banking. Neither bank, however, focuses very heavily on retail operations. A third U.S. bank — Chase

Manhattan Bank — converted its branch operation into a representative office in 1993. Chase's decision to convert to a representative office was part of a larger restructuring and was not based on dissatisfaction with local conditions or results.

As noted earlier, Chemical was one of three private banks allowed to begin operations in 1984. Chemical entered the market as a branch. In 1987, it converted into a majority-owned subsidiary with 33 percent of its stock placed in the local market. Chemical has consistently been one of the most profitable banks in Portugal. It also enjoys one of the highest solvency ratios and lowest cost structures in the Portuguese banking system.

Citibank entered the market as a representative office and converted into a majority-owned subsidiary in 1988. Like Chemical, Citibank is a profitable bank and enjoys better than average solvency and cost ratios.

In June 1993, Chemical Bank and Citibank collectively had 155.6 billion escudos in assets, or 1 percent of the total financial assets of Portugal's banking system. Both banks have decided not to expand aggressively into the heavily banked retail market, but instead to pursue other more profitable market niches.

Chemical Bank is very active in various wholesale niches. It is a market leader in the medium- and long-term syndicated loan market. Chemical also is active in the securities and foreign exchange market as both an investor and as a trader. It fully owns a mutual fund and a factoring company. Chemical plans to participate in the derivatives market when Portugal develops a derivatives market.

Citibank also has focussed on the wholesale end of the market. Citibank is a leader in corporate transactional business, project financing, Treasury products, and custodial services. Much of this business is supported by Citibank's London operations. It also intends to be active in the derivatives market.

Chase Manhattan concentrates on corporate lending and project finance.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks face no legal constraints on establishment as branches or as subsidiaries. Subsidiaries, either established de novo or acquired, may be 100 percent foreign-owned.

The capital requirements are the same for foreign branches and subsidiaries. The foreign branch must secure a capital commitment from the parent to satisfy this requirement (currently PTE 3.5 Billion = about $23 million). The prudential limit for the foreign branch is based on the foreign branch's own capital imported from the parent.

Portuguese authorities limit foreign participation in acquisitions of state-owned banks being privatized. The authorities set 25 percent foreign ownership as a guideline but have the discretion to specify a higher or lower percentage on a case-by-case basis. The limit does not apply to foreign acquisition of private banks or securities firms although government authorities have the discretion to veto any acquisition (foreign or domestic) if they determine it creates "market imbalances." This limit on foreign acquisitions of state-owned banks being privatized is the one area that raises questions about government of Portugal transparency and national treatment of both fellow EU and non-EU banks.

Otherwise, U.S. bankers report that they receive the same treatment from host regulatory authorities as do national banks. U.S. subsidiaries can open as many branches or ATMs as they want and the establishment fees are the same as for local banks. U.S. and domestic banks pay identical fees for entry/expansion.

U.S. banks actively participate in all segments of the financial system. While no U.S. bank is present in branch form, apparently this reflects investor choice rather than impediments to entry or operation.

Foreign banks face no funding constraints, or impediments to the introduction of new products, different from those faced by domestic banks. There are no limits on financing maturity structures.

U.S. firms are allowed to participate in all aspects of the privatization process e.g., valuation, due diligence, underwriting, and sale.

PORTUGAL

SECURITIES

SUMMARY

As part of Portugal's effort to develop its small capital market, the country's two stock exchanges were privatized in 1991 and an "SEC-like" regulatory agency was established.

The lifting of capital controls at the end of 1992 brought about renewed foreign investor interest in Portugal's local capital market. Foreign holdings of government securities increased from about 3 percent of total government debt outstanding at the end of 1992 to about 18 percent at the end of 1993.

Current market capitalization totals about 43 percent of GDP. Public debt instruments account for almost 57 percent of total capitalization, and 78 percent of secondary market trading. Trading in equities is thin, with financial stocks accounting for a disproportionate share of the total. The announced privatization of the cement, utilities, and telephone companies should help to broaden the equities market.

The U.S. direct presence in the market is limited to Chemical Bank and Citibank, both of which specialize as dealers in government securities. To the extent other U.S. securities firms are involved in the Portugal market, they conduct their business through local securities firms.

With the exception of legal limits on foreign investment in privatizations, an area of potential interest to U.S. firms, U.S. financial institutions contacted reported no instances of discrimination.

Portugal's financial services laws and regulations are being brought into conformance with EU directives.

DESCRIPTION OF THE MARKET

Organization and Regulation

The Securities Market Act of 1991 established the current framework of the Portuguese securities markets. There are two private stock exchange associations in Portugal, the Lisbon and the Oporto Stock Exchange Associations. The two stock exchanges currently compete with separate spot markets, but most stocks traded are also quoted on a national continuous market. The Lisbon Stock Exchange handled about two-thirds of the secondary market trading volume in 1993.

There are two official entities with various responsibilities for securities market supervision. The Securities Market National Council is a consultative body of the Finance Ministry that provides opinions on all major securities legislation. The Securities Market Commission (CMVM) is an autonomous public entity that regulates, supervises, and oversees the national securities market.

Recent Developments

The primary market experienced disappointing results in 1993 with 561.3 billion escudos ($3.5 billion) in debt and equity issues. Stocks have not been a traditional vehicle for Portuguese firms to raise capital. New stock issues totaled only 88.7 billion escudos ($551 million), a fall of 20 percent compared to 1992 levels. Government bond issues dominated primary market issues, as well as secondary market trading.

Conversely, 1993 proved to be a banner year for the Portuguese secondary market as savers looked for alternatives to the low interest rates being offered on bank deposits. Trading volume expanded nearly 80 percent in 1993 over 1992, reaching a total of 4.3 trillion escudos ($27.3 billion at the average 1993 exchange rate). Equity prices, as measured by the BVL general index, rose 53 percent.

Issues in the Primary Market, 1991-1993
(billions of escudos)

	1992 Volume	Percent of Total	1993 Volume	Percent of Total
Private Placements:	299.5	32.0	S49.1	35.0
Stocks	56.1	6.0	100.0	6.0
Corp. Bonds	201.0	21.0	320.0	20.0
Caravela [1]	41.9	4.0	104.1	7.0
Other Bonds	0.5	1.0	25.0	2.0
Public Offerings:	645.3	68.0	1,029.7	65.0
Stocks	65.5	7.0	48.4	3.0
Corp. Bonds	154.0	16.0	43.4	3.0
Govt. Bonds	425.8	45.0	937.9	S9.0
Total	944.8	100.0	1,578.8	100.0

[1]Nonresident multilateral development bank escudo-denominated issues.
Note: Excludes about PTE 200 BN in commercial paper

Secondary Market Transactions in 1993

	Volume (billions of escudos)	Percent of Total
Corporate Bonds	1,183	28.0
Government Bonds	2,267	58.0
Stocks	780	18.0
Participation Shares	15	0.3
Investment Trust Units	38	0.7
Total	4,283	95.0

The market value of publicly traded securities totaled 7 trillion escudos ($38.9 billion) in 1993, or 43 percent of GDP. Of this amount, the market capitalization of 183 actively traded stocks

totaled 2.2 trillion escudos ($13.6 billion), or 15.2 percent of GDP. Government bonds totaled 3.9 trillion escudos; private bonds totaled 0.9 trillion escudos; and commercial paper, a new instrument introduced in August 1992, totaled 167 billion escudos ($1 billion).

1993 Market Capitalization

	Amount (trillions of escudos)	Percent of Total
Stocks	2.2	30.0
Public Bonds	3.9	55.8
Private Bonds	.9	12.8
Commercial Paper	.1	1.4
Total	7.0	100.0

The government's privatization of the financial sector, largely through public equity offerings, has been a major stimulus to the development of the stock market in recent years. Financial stocks represent 53 percent of total stock market capitalization and are the most actively traded stocks, accounting for 63 percent of secondary market trading volume. Four of the top five stocks in terms of trading volume in 1993 were financial stocks.

Nevertheless, the secondary market is thin, fairly illiquid, and concentrated. The top 10 traded stocks accounted for 63 percent of total trading volume in 1993. Daily turnover rose from 2 billion escudos at the end of 1992 to about 18 billion at the end of 1993.

There are 109 investment funds operating in Portugal, with 155 billion escudos under management. Fourteen of these funds are foreign. With complete liberty of capital movements permitted in December 1992, foreign investors increased their purchases of government securities, a trend that is expected to continue.

Two developments are likely to provide significant stimulus to deepening of the securities market over the next few years. The government has indicated its intention to privatize its cement, utilities, and telecommunications holdings. It is believed that stock market capitalization could double by these forthcoming privatizations. Second, the government is expected to approve the creation of the first Portuguese derivatives market, to be managed by the Oporto Stock Exchange.

U.S. PRESENCE IN THE MARKET

U.S. presence in the securities markets is limited to Chemical Bank and Citibank. Both banks have been granted status as specialized dealers in treasuries and are very active as investors and traders. Bonds and other fixed-rate securities amount to about 50 percent of Chemical Bank's total assets. Collectively, Chemical and Citibank account for about two-thirds of the total profits of the 15 foreign banks in Portugal.

Other large American securities entities are active in the Portuguese securities market through Portuguese intermediaries (i.e., local brokerage firms and investment and commercial banks). This indirect approach to the market appears to be based on efficiency and cost considerations rather than to any legal discrimination. This may change, however. Salomon Brothers recently announced that it would establish a joint venture in Portugal to focus on the upcoming privatizations.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks and securities firms face no legal constraints on establishment in Portugal either as branches or as subsidiaries. One hundred percent foreign ownership of local subsidiaries is permitted. However, with respect to acquisitions of financial institutions in general, the government has the discretion to veto any acquisition (foreign or domestic) that might lead to "market imbalances."

Foreign securities firms established in Portugal as subsidiaries or by acquisition may engage in underwriting, brokering, and dealing in both foreign and domestic securities on the same basis as domestic firms. Foreign firms have access to exchange seats on the same basis as domestic firms.

Foreign banks and foreign securities firms do face constraints on expansion via acquisitions. In the case of acquisitions of state-owned financial institutions being privatized, the government limits foreign ownership to 25 percent, although the government has the discretion to specify a higher or lower percentage on a case-by-case basis. Otherwise, U.S. firms are allowed to participate in the privatization process, e.g., valuation, due diligence, underwriting.

Foreign securities firms may introduce new financial products on the same basis as domestic firms. There are no limits on maturity structures.

Foreign securities firms established in Portugal may offer the same fund management services as domestic firms. However, Portugal has not yet implemented the UCITS Directive which established an EU single market for mutual funds. The government expects to have legislation in place to implement the Investment Services Directive by December 31, 1995.

There are no limits on investment by foreigners in local equity and debt issues other than those noted above. Residents may freely invest in foreign securities, as well as raise funds abroad. U.S. firms have participated in both offshore investments and offshore securities issues.

Exchange Rates

Average 1993:	US$1 = 160.80 escudos
End of year 1993:	US$1 = 176.81 escudos

SPAIN

BANKING

SUMMARY

Following a series of mergers in the late 1980s and early 1990s, six large banking groups have come to dominate the banking activity in Spain's financial sector. With its April 1994 purchase of a controlling interest in Banesto, Banco Santander vaulted into first place in the Spanish market and is now the 22nd largest bank in Europe and 45th largest bank in the world. The generally profitable dominance by the "Big Six" of the Spanish market is maintained, in part, through their extensive branch network; Spain has more branches per inhabitant than almost any other European country.

Of the 163 banks in Spain, 22 are subsidiaries of foreign banks, 26 are branches of non-European Union (EU) banks, and 27 are branches of EU banks. Six U.S. banks are active in Spain through branches or subsidiaries.

Spain's treatment of non-Spanish financial institutions is increasingly subject to EU regulation. Spanish legislation fully implementing the EU's Second Banking Directive became law on April 15, 1994 (parts of the directive had been implemented earlier). In some ways this will provide U.S. banks with opportunities to simplify their operations in Spain (as part of their European strategies).

However, Spain does discriminate against non-EU branches by limiting their operations based on the amount of their local capital whereas limits on branches of EU banks are based on the parents' worldwide capital. The Bank of Spain, which supervises the Spanish financial system, has expressed a willingness to negotiate a solution to this problem with the U.S. government.

DESCRIPTION OF THE MARKET

In anticipation of changes in the banking market, resulting largely from EU legislation, Spanish banks began a series of mergers in the late 1980s and early 1990s. Recently, Banesto was acquired by Santander, making it the largest bank in the country.

The Association of Private Banks (AEB) reports that 136 banks are active in the Spanish market. This figure does not include the 27 branches of banks from other EU countries or representative offices.

The six largest banks continue to dominate the banking market. Each of the six banks heads a group of associated banks and other financial firms. Both Santander and Popular have been among the top five banks worldwide in profitability during the last three years.

In general, Spanish banks dominate activity in the domestic banking market by virtue of their extensive network of branch offices: 17,636 branch offices and 14,485 savings bank offices. Spain has the most branches per inhabitant of any European country.

Recent Developments

Intervention by the Bank of Spain to change the management, ownership and strategy of the Banco Español de Credito (Banesto) on December 28, 1993, brought the year to a spectacular close. One of Spain's "Big 6" banks, with assets of nearly 6 trillion pesetas (approximately $44 billion) and extensive industrial holdings, the Banesto group reportedly lost approximately 577 billion pesetas (about $4.2 billion) in 1993. Alleging mismanagement, the Bank of Spain replaced Banesto's senior management and launched a rescue plan. This involved a substantial (but not complete) write-down of Banesto capital, absorption by the Deposit Guarantee Fund (FGD) of the losses on some risky loans, and an injection of roughly $2 billion by the FGD — half of that amount covered by the Bank of Spain and half by FGD shareholders. In addition, in April 1994, Banesto issued new shares that were purchased first by the FGD, and then sold to investors at auction. Through this resale a controlling interest in Banesto was purchased by Santander, making it the largest bank in Spain as well as 22nd largest in Europe and 45th largest in the world.

For the rest of the banking sector, 1993 was a good year. Pre-tax profits for the sector (excluding Banesto) increased by 4.8 percent to 595 billion pesetas (about $4.3 billion). After-tax income reached 425 billion pesetas. The remaining "Big Five" bank — Santander, Banco Bilboa Vizcaya (BBV), Central Hispano (BCH), Argentaria, and Popular — earned over $250 million each. Seventeen banks lost money, of which nine were Spanish and eight were subsidiaries of foreign banks.

The recession and falling interest rates led to a large reduction in financial margins. In addition, provisions for bad loans increased 27 percent to 401 billion pesetas (approximately $2.9 billion). However, commission income increased 4.1 percent to 379 billion pesetas. More importantly, income from financial operations tripled compared to 1992, reaching 428 billion pesetas. About 60 percent of this income can be traced to price increases of long-term government bonds as interest rates declined by more than 400 basis points.

Savings Banks

Spanish savings banks (Cajas de Ahorro) are nonprofit mutual savings institutions that account for approximately one-half of Spanish deposits. These 52 institutions (down from 83 in 1983 due mainly to mergers) are generally administered by regional governments. In general, they do not pay as high a rate of interest on deposits as do regular banks, but they have maintained a broad customer base over the years due to their previous domination of consumer lending and their extensive branch networks (14,485 branches). Some savings banks already figure amongst the largest financial institutions in the country. Two of the 10 largest Spanish credit institutions are savings banks: La Caixa de Barcelona and Caja Madrid. La Caixa de Barcelona is reportedly the second largest savings bank in Europe. The savings banks tend to trade mostly on behalf of customers (especially property mortgages) and small and medium-sized businesses.

Foreign Banks in Spain

Over 28 percent of the capital of the five largest private banks in Spain is owned by foreigners, including 49.3 percent of Banco Popular and 23 percent of Argentaria. Of the 163 banks active in Spain, 22 are subsidiaries of foreign banks, 26 are branches of non-EU banks, and 27 are branches of EU banks. (Note: These numbers reflect the number of banks with a presence in Spain, not the number of branches of each bank).

Foreign banks with a particularly strong presence in Spain include the following:

- Deutsche Bank, which bought Banco de Madrid in 1993 and now has about 400 branch offices;

- Credit Lyonnais, which bought Banco Commercial in 1990 and Banco Jover in 1991; it now has over 300 branch offices;

- Barclays, which bought a bankrupt bank in the early 1980s and now has about 230 branches; and

- Natwest, which has built up a 200-plus branch network via a joint venture with the March Group dating from 1989.

Supervision

Oversight and regulation of the financial sector is exercised by the Bank of Spain. As of April 1994, the Bank of Spain became semi-independent, with lines of authority running through the Minister of Economy and Finance. In accordance with EU requirements, the Bank of Spain was granted independence from political authorities in June 1994.

Private banks — including subsidiaries and branches of foreign banks — are organized into the Spanish Association of Private Banks. The president of this organization, along with the chief executives of the six largest banks, are the key spokesmen for the banking sector.

Savings banks are organized into the Confederacion Espanola de Cajas de Ahorros (CECA — Spanish Confederation of Savings Banks).

ATM Networks

Three ATM networks dominate the Spanish market. The leader is "Red 6000," with 13,346 cash machines. This "network of networks" is managed by the association of savings banks, CECA. The second largest network, Telebanco/Sistema 4B, has 5,700 cash machines. The smallest network, Servired, has 3,111 machines. Each of these networks is associated with one or more European-wide networks. Citibank — the only U.S. bank with an extensive involvement in consumer banking in Spain — participates in the Servired ATM network.

Deposit Insurance

Deposits in banking institutions are insured through the Deposit Guarantee Fund (FGD), which is supervised by the Bank of Spain. Insurance premiums are assessed at 0.02 percent of eligible deposits. This premium was increased from 0.015 percent on January 1, 1994, in order to help the FGD meet the costs of bailing out Banesto.

Spanish Banks Abroad

Spanish banks have not sought to expand aggressively into the rest of Europe. They generally maintain only a limited branch operation in the major European capitals aimed at servicing Spanish client needs in those countries. The exception is in Portugal where BBV has a modest retail network that it purchased from Lloyd's Bank. Argentaria has a small network through its Banco Exterior operations. Central Hispano has a few offices and owns a stake in a Portuguese bank. And Banesto owns 50 percent of Banco Totta y Acores.

All of the Big 6 banks have networks throughout Latin America, with at least representative offices in all major capitals. Central Hispano has 32 branch offices in Chile, a 22-branch network in Argentina, and 14 branches in Paraguay. Santander has operations in Chile and Uruguay. Banesto controls Banco Shaw in Argentina and also has operations in Uruguay and Chile.

Spanish banks have about 25 percent of the market in Puerto Rico, of which BBV has 10 offices and BCH has 22 offices. Santander has 50 offices as Banco Santander, and 20 as Santander National Bank. The largest Spanish banks generally maintain branches in New York and/or Miami. All of the branches are state licensed. Banco Santander owns a significant share of

First Fidelity Bank of Philadelphia, and BBV owns a minority interest in a bank in New Mexico.

U.S. PRESENCE IN THE MARKET

Six U.S. banks have branches and/or subsidiaries in Spain, while several others maintain representative offices. In the early 1990s, several U.S. banks withdrew from Spain (First Chicago and First Interstate among others). In some cases, this was due to narrow margins or high dependence on loans to big companies. Others withdrew (including some with profitable operations) in response to a change in marketing strategies by the home office. In 1991, Chase Manhattan sold its subsidiary to a Portuguese savings bank, but retained its branch.

In 1993, Chemical Bank, Bank of America, and Morgan Guaranty were among the 15 most profitable banks in Spain, with after-tax profits of $77.7 million, $65.3 million, and $59.7 million, respectively. Citibank's branch made profits of $28 million, but its subsidiary lost $9.8 million. Chase Manhattan made $6.6 million, and Bankers Trust earned $1.9 million.

The Citibank subsidiary is the only U.S. bank that is active in Spain's retail banking market. Citibank España has 100 branches in Spain and is a leading participant in one of Spain's three ATM networks. The other U.S. banks are more concentrated on private and corporate banking — including management of corporate treasuries, project finance, and loan syndication.

The following table depicts the U.S. presence in Spain at the end of 1993:

Bank Branches	Number of Employees	Offices	Profits (millions pesetas)	Assets (millions pesetas)
	47			
Bankers Trust		1	240	332,798
Chase Manhattan	86	2	839	14,739
Chemical	128	5	9,863	306,438
Citibank NA	159	2	3,555	265,680
Morgan Guaranty	146	2	7,586	631,406
Subsidiaries:				
Bankers Trust	47	1	240	332,798
Bank of America	179	3	7,595	465,857
Citibank Espana	1,172	98	(1,241)	297,654

Note: In addition, three U.S. banks have representative offices in Spain, including Chemical, which has both a representative office and a branch.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Over the past few years, the Bank of Spain has welcomed the entry of subsidiaries and branches of U.S. and other foreign banks. Subsidiaries are treated like national banks and face no special funding constraints. Branches are limited to a maximum of four offices.

Spain's treatment of foreign banks is now subject to European Union regulation. Spanish legislation implementing the EU's Second Banking Directive became law on April 15, 1994. While implementing the EU's single market liberalization, the SBD has the effect of placing non-EU direct branches at a relative disadvantage in some EU countries, including Spain. This is because of local capital requirements upon which lending and other operations have been based, instead of permitting these operations to be based upon parent capital. The SBD prohibits local capital requirements for EU banks, but treatment of non-EU direct branches is left to the discretion of the host country. For U.S. and other non-EU banks in Spain, the maintenance of the local ("dotation") capital requirement raises cost and imposes limitations on foreign exchange exposure. As of October 1994, the Bank of Spain has granted each U.S. branch a temporary exemption from these requirements.

Although Spanish law does not discriminate against non-Spanish banks, there are instances of informal discrimination in favor of the Big Six banks, all of which are Spanish. Contact

between these large banks and the Bank of Spain is more frequent than for other banks — perhaps a natural result of their relative size.

U.S. banks operating in Spain have few complaints about Spanish government discrimination (other than the dotation capital issue described above).

Major Spanish Banks, 1993
(billions of pesetas)

Institution	Assets	Net Profit
The Big Six		
Argentaria*	11,555	44.2
Central Hispano (BCH)	11,223	47.0
Banco Bilbao Vizcaya (BBV)	8,918	60.2
Santander	7,350	60.8
Banesto (Purchased by Santander-April 1994)	5,639(Nov. 93)	(loss)
Popular	1,749	39.7
Largest Savings Banks		
La Caixa (Savings Bank)	7,000	39.4
Caja Madrid (Savings Bank)	4,300	32.4

*Argentaria, although treated as one of the Big Six banks, is a holding company. Its largest component is Banco Exterior de España (BEX) with assets at end-1993 of approximately 4,500 billion pesetas.

Source: Assets: Consejo Superior Bancario
Profits: Press Reports

Number of Banks, Offices, and Employees in 1993

	Banks	Savings Banks
Number of Entities	163	52
Number of Offices	17,636	14,485
Number of Employees	152,830	82,708
Deposits (Bil. Pesetas)	19,055	19,858

Source: Bank of Spain

Bank Assets, December 31, 1993
(billions of pesetas)

	Total	Spanish Banks	Savings Banks	Foreign Branches	Foreign Subs
Total Assets	100,339	52,674	33,654	8,667	5,344
Financial system	24,189	12,839	8,315	1,607	1,429
Government	14,460	7,002	5,553	1,166	739
Other resident	39,070	19,664	15,278	1,749	2,379
loans	36,250	18,101	14,100	1,717	2,332
bonds	853	279	534	31	10
shares	1,966	1,286	643	1	36
Claims on nonresidents	16,484	10,056	2,288	3,640	500
Other	6,135	3,112	2,220	506	298
Liabilities	100,339	52,674	33,654	8,667	5,344
Financial system	23,345	13,471	3,038	5,277	1,559
Government	2,587	1,640	841	13	94
Other resident	49,388	22,135	24,533	403	2,317
Nonresident	12,288	8,405	961	2,226	696
Other	12,731	7,023	4,282	749	677

Source: Bank of Spain

SPAIN

SECURITIES

SUMMARY

The Spanish stock, bond, and futures markets have changed dramatically in the last 10 years, modernizing significantly and becoming much more integrated into the European and world financial markets. The stock market enjoyed a boom year in 1993, both in volume and in value, driven in part by the rapidly growing interest of foreign investors attracted by falling interest rates.

Although Spain has four securities exchanges, most trading currently occurs on the electronic, "continuous" market. Over seven hundred firms are listed on the various exchanges, but most trading involves the 35 firms included in the IBEX-35 index. The National Commission for the Securities Markets (CNMV), a government agency established in 1989, oversees the exchanges. Government debt dominates bond trading. The market for futures and options, in operation since 1991, became particularly active during 1993.

Spain has 124 registered securities dealers, including several firms fully or partly owned by U.S. securities firms. Two U.S. banks are "primary dealers" in Spanish government debt. The U.S. firms are welcomed by Spanish authorities. There are no significant impediments to capital movements and U.S. firms conduct much of their Spanish business cross-border. As part of the European Union, Spain has transposed, or is in the process of transposing, the EU Financial Services Directives into national law.

DESCRIPTION OF THE MARKET

The Spanish securities market has changed dramatically in recent years, following the enactment of the Securities Law of 1988, the introduction of continuous trading in 1989, the creation of 10-year government bonds in 1990, development of a futures market in 1990, and complete foreign exchange liberalization since January 1993. These and related changes have transformed the Spanish securities market into one of the most modern and fastest-growing markets in Europe. There are no specific impediments to introducing new financial instruments.

The rapid modernization of the Spanish financial/securities market has been driven largely by the legal and competitive requirements of Spanish membership in the European Union (since 1986). Spain is subject to all of the relevant EU directives, most importantly the Investment Services Directive and the Second Banking Directive. Legislation transposing the latter into Spanish law became effective April 15, 1994.

The Equities Market — Organization

Spain has four stock exchanges trading fixed-rate private and public fixed-income securities (e.g., bonds) along with equities. Traditionally, about 80 percent of these transactions took place on the Madrid Exchange (Bolsa), with Barcelona, Bilbao, and Valencia sharing the remaining 20 percent. This has changed since the introduction of computerized, continuous trading in 1990, which now accounts for some 90 percent of transactions.

The continuous market is a system of computer transactions that operates from 10 a.m. through 5 p.m. The 53 participating brokers, which are members of one or more of Spain's four stock exchanges, are connected to this network, where buy and sell orders are matched automatically by computer. These operations, along with other Bolsa transactions, are settled through the Compensation and Liquidation of Securities Agency (SCLV), which belongs to private-sector financial institutions. The SCLV allows five business days to complete settlement. Approximately 100 of the most heavily traded shares are listed on the continuous market.

Oversight of the securities market is exercised primarily by the National Commission for the Securities Market (CNMV), which was created by the Securities Law of 1988. Along with the president of the CNMV, the Board of Directors includes senior officials from the Bank of Spain (Spain's Central Bank) and from the Ministry of Economy and Finance. The CNMV signed a bilateral agreement (MOU) with the SEC in July 1992, and with the Commodity Futures and Trading Commission (CFTC) in October 1992. It has similar agreements with comparable supervisory agencies in Argentina, Chile, Colombia, and France.

Under the reforms included in the 1988 Law, individual broker members of the exchange were replaced by securities companies and brokerage firms. There are 124 securities dealers in Spain. There are two types of securities dealers: "agencia de valores" (securities agencies) that trade only on behalf of investors, and "sociedades de valores" (securities-dealer companies) that trade also on their own behalf, but require higher capitalization.

The Equities Market — Activities

There are 616 firms traded on the Spanish equity markets, which include the four stock exchanges and the continuous market. Four of these firms are foreign. Capitalization totalled 21.253 trillion pesetas ($167 billion) at the end of 1993, while turnover in 1993 totalled 6.5 trillion pesetas ($51 billion) — a 46 percent increase over 1992. The 10 largest firms listed account for over one-half of both capitalization and turnover. Banks account for 33.5 percent of capitalization in the continuous market, while power and water utilities account for 21.2 percent, and transport and communications another 11.2 percent. Approximately 9 percent of turnover was accounted for by the government's sale of 49 percent of Argentaria, one of Spain's largest banks.

The two major indices are the Total Index of the Madrid Stock Exchange (a composite of all stocks listed on that exchange), and the IBEX 35; the latter includes only the top 35 companies. The Total Index ended 1993 at 322.77, an historic high and an increase of 48.9 percent over the 1992 closing level. The IBEX-35 reached its peak in late December 1993 at 3,616.36, an increase of 54 percent over January 1, 1993. In an atmosphere of macroeconomic recession and declining business profits, these strong performances were driven by declining interest rates — the key Bank of Spain intervention rate declined by over 400 basis points during 1993.

Net purchases of equity shares by nonresidents increased from 306 billion pesetas in 1992 to 768 billion pesetas (approximately $6 billion) in 1993. Purchases by nonresidents of 2.9 trillion pesetas and sales of 2.1 trillion pesetas accounted for 38 percent of transactions on Spanish equity markets.

The shares of 17 Spanish firms are traded on the New York, London, and Frankfurt stock exchanges.

Money Markets

In 1982, the money market was transformed from a purely interbank funds market into an open money market with the introduction of the bearer T-bill (pagaré). The registered T-bill (letra) introduced in 1987 completed the consolidation of the market, which the public can now participate in directly, or indirectly through money market funds. The Bank of Spain uses 10-day auctions to set money market interest rates.

The market for commercial paper also can be considered part of the money market, although it is generally traded on the AIAF (see below) and quantities are relatively small compared to interbank and short-term government debt. The commercial paper market is growing rapidly, however. The stock of commercial paper outstanding was 745.7 trillion pesetas on December 31, 1993, a 54 percent increase over end-year 1992. Short-term debt is issued by 32 commercial institutions, but the state railroad company "RENFE" accounted for 22.5 percent of trading volume in 1993.

The Bond Market

The fixed-income (bond) market in Spain has developed rapidly since the 1990 introduction of 10-year Treasury bonds. The government's financing needs caused an increase in negotiable public debt outstanding from 19.5 trillion pesetas in 1992 to 26.1 trillion pesetas (approximately $200 billion) at the end of 1993. In addition, private Spanish firms issued bonds (short- and long-term) worth 3.7 trillion pesetas (about $29 billion) in 1993. Ten firms accounted for 59 percent of that debt. Nonresidents have purchased 29.3 percent of public sector bonds outstanding. In addition to the direct placement of bonds, there is now an active electronic

secondary market for bonds utilizing the same computer network as the "continuous" market for equities.

Public Debt. Public debt instruments are mostly traded on the "annotated public debt market," which is an official market functioning by telephone and computer terminals, supervised and regulated by the Bank of Spain. In addition to the Bank of Spain, direct participants include all interested banks (and savings banks) located in Spain, and the 124 authorized brokerage agencies (sociedades and agencias de valores). Most of the U.S. banks in Spain are active in this market. A small share of public debt transactions occur on the Stock Exchange (Bolsa) described above.

Debt purchases are registered in the "annotations office." This office maintains two groups of accounts: direct accounts and market accounts. The first group is designed for smaller investors who hold the debt to maturity. In order to be traded on the secondary market, the debt must be transferred to a market account, which is managed by a financial intermediary.

The principal debt instruments are Treasury bills ("letras") and bonds. The bills are issued in one million peseta units for 3, 6, or 12 months. First introduced in 1987, they are sold at auction with interest rates implicitly determined by the discount. Notes have 18-month terms, are sold in units of 500,000 pesetas, and have an interest rate fixed administratively — at 5.5 percent since 1989. The notes, introduced in 1981, have some tax advantages, but have not been issued since late 1992. Bonds are sold with maturities of 3, 5, 10, and 15 years, with 10-year bonds being the most commonly traded. Nominal value is 10,000 pesetas; interest is paid in coupons and the bonds are sold at auction.

Spain's public debt market has developed rapidly since 1990, when futures and options were first introduced. Negotiable public debt outstanding has increased from 590 billion pesetas (3 percent of GDP) in 1982 to 25 trillion pesetas (47 percent of GDP) in 1993. From 1992 to 1993, the government increased the average maturity of outstanding debt from 1.86 years to 2.92 years to take advantage of the negative yield curve (in January 1993, 3-month bills averaged 14.1 percent interest, while 10-year obligations averaged 12.49 percent). In 1993, more than 85 percent of net government debt issues were in long-term bonds, compared to less than 20 percent in 1990.

Private Debt. Most private debt instruments are traded on the "organized non-official secondary market," called the AIAF (Association of Intermediaries in Financial Assets). The AIAF is supervised by the CNMV. Compensation, liquidation, and registration is handled by ESPACLEAR, since June 1989. The AIAF is operated by its 124 members, all of which are financial intermediaries, including domestic and foreign banks, savings banks, and brokerages. Most of these firms are also shareholders in ESPACLEAR.

Futures and Options

Spain's market for futures and financial options grew rapidly in 1993. More than 21 million contracts were transacted in 1993, triple the 1992 level. This market dates since only December 1991, with the creation of the MEFF (Spanish Market for Financial Futures). More than one-half the transactions involve the IBEX-35 equities index, especially 90-day futures and options. The value of a contract traded in this market is based on the index times 100. Futures and options are also widely traded on 10-year government bonds and on the MIBOR (Madrid InterBank Offer Rate). Madrid's futures market for foreign exchange (dollars and Deutshemarks) declined significantly during 1993.

Participation of nonresidents in these markets more than doubled during 1993, accounting for 23 percent of IBEX contracts, 25 percent of the debt contracts, and 30 percent of contracts based on the MIBOR.

U.S. PRESENCE IN THE MARKET

Of Spain's 124 securities dealers, U.S. firms own significant shares (up to 100 percent) in five. Only one U.S. firm, J.P. Morgan, is a member of the Bolsa. It is engaged extensively in most facets of the market. Merrill Lynch is registered as a securities broker (Agencia de Valores), although this is not essential to its main lines of business — servicing large clients investing outside of Spain and placing or managing new securities issuances in overseas markets. Lehman Brothers is engaged in similar activities, but it is not registered as a securities broker. Several other U.S. securities firms have purchased significant shares of Spanish securities agencies; Kidder Peabody, for example, owns 25 percent of the large Spanish broker Benito y Monjardin.

J.P. Morgan and Bank of America are "primary dealers" in government debt. According to Spanish officials, other U.S. firms could also obtain that designation if they desired. Several U.S. firms are authorized "market makers" in the options and futures markets for government debt.

The lifting of capital controls in recent years (a process completed in January 1993), has allowed U.S. securities dealers to offer brokerage services to Spanish clients for U.S. and other non-Spanish securities. U.S. firms in Spain facilitate real-time connections to their London or New York offices, where the transactions actually occur. For example, Spanish investors have immediate access to U.S. mutual funds, although these funds are not counted among the 56 foreign investment funds marketed in Spain (all 56 are based in Luxembourg, the U.K., or Belgium.)

U.S. securities firms also provide advisory services to Spanish firms in placing new offerings, both in the United States and worldwide.

The EU's Investment Services Directive will enter into force on January 1, 1996. Once it is transposed into national law, any securities firm incorporated within the EU will be able to provide securities services in Spain, either through a branch or directly from its home country. There are no formal or informal restrictions affecting the entry of U.S. firms into this market, other than the regulatory and capital requirements affecting all firms, including Spanish.

Merrill Lynch recently announced that it will convert its Spanish securities operation into a branch of its London bank. Apparently this is a direct result of the new possibilities offered under the EU's Second Banking Directive, which entered into force on January 1, 1993. (See the chapter on the European Union for additional details.)

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no significant discriminatory barriers to establishment for U.S. firms. In fact, the Spanish government seems to be interested in attracting the participation of leading international firms in the Spanish market as part of the modernization process. Non-EU firms do need to request permission to access the securities markets, although it is highly unlikely that the government of Spain would deny access to qualified U.S. firms.

With few exceptions, once established, U.S. firms receive the same treatment as Spanish firms. U.S. firms are involved in underwriting in the domestic market. However, banks must be involved as middlemen in underwriting new issues. J.P. Morgan and Bank of America are "primary dealers" in government debt.

There are no restrictions placed on U.S. or other foreign firms' participation in the futures and options market, although there are a limited number of authorized market makers. Several U.S. firms are authorized "market makers" in the options and futures market for government debt. In the equities market, there are no limitations — and U.S. firms can and do act as market makers.

The one informal restriction reportedly affecting U.S. dealers reserves for Spanish dealers the right to lead-manage issues of "Matador" bonds. These are peseta placements of bonds from international financial organizations. In 1993, Matador bonds with a nominal value of 390 billion pesetas (about $3 billion) were issued.

There are no rules discriminating against foreign institutions in fund management. Spanish law does require that investment companies manage funds, and that banks have custody of those funds. This is a control measure designed to force banks to take some responsibility for the accuracy of information about the funds.

Spanish residents' access to foreign capital markets, as well as their ability to invest abroad, is unrestricted. U.S. firms are active and unhindered in serving as brokers and underwriters in foreign markets for Spanish residents.

There is already substantial scope for cross-border access into the Spanish market, and this will increase as the EU directives are implemented for U.S. firms incorporated in the EU area.

Full regulatory transparency formally exists as far as the promulgation and applications of rules and regulations is concerned. However, it is widely believed that Spain's Big Five banks have an advantage as far as "informal consultations" are concerned.

Exchange Rates

Average 1993:	$1 = 127.26 pesetas
End of year 1993:	$1 = 142.21 pesetas

OTHER EU AND EFTA — AUSTRIA

SUMMARY

Since the establishment of the European Economic Area (EEA) on January 1, 1994, most Austrian banking and financial laws and regulations conform to those of the European Union (EU). This follows a trend towards greater liberalization that included the removal of restrictions on cross-border capital transactions in 1991, and the deregulation and opening of capital markets in 1992.

Austria has a universal banking system. Banks may engage in a full range of banking and securities activities. Austria's eight largest banks comprise 49 percent of total bank assets in Austria. Foreign banks in Austria account for less than 3 percent of total assets.

Four U.S. banks have subsidiaries in Austria, and another has a branch. They concentrate on specific market niches, such as treasury services, private banking, securities trading, trade financing, and other commercial bank services.

Austria's 1993 Banking Act presents a number of obstacles for market entry of U.S. banks. It distinguishes between banks holding a banking license from Austria or other EEA member states and banks from third countries. Branches of non-EEA banks must be licensed, while EEA banks may operate branches on the basis of their home country licenses. For bank branches or subsidiaries from a non-EEA member country, the limits for single large loan exposures and open foreign exchange positions will shrink considerably because of changes in the treatment of capital.

DESCRIPTION OF THE MARKET

The Financial Market Adjustment Act, which came into force January 1, 1994, translates most EU directives and regulations into Austrian law. Only two EU directives, one on large loan exposure and the other on consolidation of annual reports, remain to be implemented, and this should occur by January 1, 1995.

Banks

The banking sector comprises many small banks. In 1993, there were 1,063 bank headquarters and 4,691 branches. By international standards, even Austria's large banks are relatively small. Corporate banks account for 29.1 percent of the sector, savings banks 30.4 percent, agricultural credit cooperatives (Raiffeisen) 19.7 percent, trade credit cooperatives (Volksbanken) 4.3 percent, and other banks (mortgage banks, building societies, etc.) 16.5 percent. Although these subsectors still exist, Banking Act provisions and competitive pressure have blurred sectoral distinctions, with the result that most Austrian banks are acting as all-purpose banks. Austria's

eight largest banks comprise 49 percent of total bank assets in Austria, foreign banks in Austria account for less than 3 percent.

The state has an important stake in banking. The federal government holds a 22.5 percent share in Bank Austria, Austria's largest bank, and a 49.35 percent share, 70 percent of the voting shares, in Creditanstalt Bankverein, Austria's second largest bank. The government acts as guarantor for all liabilities of the Postal Savings Bank (Oesterreichische Postsparkasse), and through the Austrian Kontrollbank operates an export guarantee and financing system. Other major shareholders in banks are institutional investors, associations, cooperatives, communities, and savings unions. Direct private shareholding and ownership is of little significance. Despite the large number of banks, the Austrian banking system is characterized by a high level of concentration in ownership, with banks holding substantial interests in other banks and financial institutions. For example, Bank Austria holds direct and indirect equity interests in nine Austrian banks and 20 financial services companies.

After write-offs of losses from aggressive overseas lending, particularly to Eastern Europe, and from domestic bankruptcies, 1993 balance sheets showed a clear improvement over 1992. Net interest income rose 12 percent in 1993, fee and commission income rose 17.5 percent, operating income from banking activities increased 45 percent, and profits after taxes and reserve allocation rose almost 50 percent. Nevertheless, despite improved earnings, the profitability of Austrian banks remains unsatisfactory by international standards.

1993 was marked by low growth in savings deposits and a trend toward high interest bearing accounts. Direct credits to domestic nonbanks expanded moderately in 1993. Foreign assets rose by Austrian schillings (AS) 96.5 billion or 10.5 percent to AS 1,012 billion in 1993, while foreign liabilities increased by AS 39.1 billion or 3.7 percent to AS 1,088 billion. At the end of 1993, total assets of all banks were up 6.3 percent to AS 4,827 billion. At 5.1 percent, the ratio of equity and required reserves to deposits and contingent liabilities was unchanged from 1992.

Total Bank Access in Austria
(in AS billion)

	1992	1993
Total Assets	4,540.5	4,826.7
-- of which: foreign assets	915.9	1,012.4

Austria's Eight Largest Banks by Asset Size, 1992
(in AS billion)

Bank Austria	544.9
Creditanstalt Bankverein	517.9
GiroCredit	324.2
Bank fuer Arbeit und Wirtschaft (BAWAG)	205.2
Postsparkasse	204.1
Raiffeisenzentralbank (RZB)	185.1
Die Erste	180.3
Oesterreichische Volksbanken AG - Zentralinstitut	60.4

Bond Market

Gross issues in the domestic bond market in 1993 totalled AS 253.9 billion, up AS 93.1 billion from 1992. The market was dominated by bank issues and government bonds, which accounted for 55.6 percent and 37.1 percent of total volume, respectively. Foreign issues accounted for just 2 percent of volume. The net increase of AS 142.8 billion pushed outstanding fixed-interest securities in circulation to AS 1,152.1 billion by the end of 1993. The effective yield for bonds averaged 6.32 percent in 1993, compared to 7.95 percent in 1992.

Stock Market

Recovering from the "bear" year of 1992, the Vienna Stock Exchange boomed in 1993. At the end of the year, the overall stock index stood 39 percent above 1992. Total market value of all outstanding shares rose 43.4 percent to AS 330.0 billion. Stock issues by new and listed

corporations amounted to AS 16.4 billion in 1993. Since October 1, 1993, insider trading has been criminalized.

Capital Movements

There are no formal limitations on investments by foreigners in local equity and debt instruments. Investments may be direct. Since 1992, all capital controls have been removed. However, fairly exhaustive reporting requirements remain in place, which constitute a significant administrative burden to banks, both Austrian and non-Austrian. Each transaction must carry a unique reference number as it goes through the correspondent banking system, i.e., so-called "tableau" reporting.

U.S. PRESENCE IN THE MARKET

Most U.S. banks have entered the market by establishing subsidiaries — Citibank, General Motors Bank, Merrill Lynch Bank, and VB Heller Bank. Only American Express Bank operates a branch in Austria. General Electric Capital Corporation took a different approach, acquiring in January 1994 Mercurbank, with assets of AS 8,347 million in 1993.

U.S. Bank Assets in Austria
(in AS million)

	1992
Citibank Austria	6,183
American Express Bank Austria	3,109
VB Heller Bank	590
General Motors Bank	903
Merrill Lynch Bank	94

Although their licenses allow them to offer a complete range of banking services, U.S. bank branches and subsidiaries in Austria tend to concentrate on specific market niches, such as Treasury services, private banking, securities trading, trade financing, and other commercial bank services.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. banks in Austria report improved access to market information, as well as good relations with supervisory authorities and the Bankers' Association. Nevertheless, the 1993 Banking Act requires that branches of non-EEA banks, including U.S. banks, must be licensed, while banks holding a license in an EEA member country (including a U.S. bank subsidiary incorporated in an EEA member country) are free to operate branches in Austria, without the need to obtain a license. This requirement imposes additional administrative burdens. Whereas branches of banks from EEA member countries are subject to supervision only by their home country authorities, U.S. bank branches in Austria are subject to both Austrian and U.S. bank supervision.

A further competitive disadvantage imposed by Austria's 1993 Banking Act is that after a transition period ending in 1998, foreign bank branches and subsidiaries will no longer be able to add endowment capital to their capital bases used to calculate limits for single large exposures and open foreign exchange positions (paragraph 103/19 and 21 of the 1993 Banking Act). After expiration of the transition period, these new regulations will considerably reduce the limits for single large loan exposure and open foreign exchange positions of U.S. bank branches or subsidiaries. In contrast, branches from banks licensed in the EEA can operate on the basis of their parent companies' capital.

As a result of these administrative and competitive disadvantages, and in order to save costs and to make full use of the advantages of the EEA, several U.S. bank subsidiaries in Austria are considering converting their operations into branches of subsidiaries incorporated in an EEA country.

In applying for a license, non-EEA banks have to comply with two additional requirements. In the case of license applicants from third countries, reciprocity is applied. Moreover, the license can be denied on the grounds that the banking activity "is not in the national economic interest." The first requirement presents no problems, since U.S. banking laws accord (reciprocity) Austrian bank national treatment. Also, the "national economic interest" criteria has not been a problem for bona fide U.S. banks.

U.S. bank branches or their Austrian subsidiaries are free to fund their activities using any number of instruments. Presently, both branches and Austrian subsidiaries of U.S. banks have access to the discount window of the Central Bank, i.e., the Austrian National Bank. However, one U.S. subsidiary has noted that by converting to a branch of an EEA-based subsidiary, this access might be lost. Austria has no specific regulations on automated teller machines.

Foreign firms are free to underwrite equity and bond issues, provided they are registered as members of an underwriting syndicate. They have access to seats on the stock exchange.

Firms may introduce new financial products. Authorities apply BIS rules on a liberal basis to license new instruments. The basic criteria is knowledge of customers and "comfortable" provision for liquidity.

Foreign banks and/or security firms may engage in fund management activities.
Like their Austrian counterparts, they may create mutual funds and sell foreign mutual funds to local investors, provided that nondiscriminatory registration procedures, described by some as "expensive," are followed.

Proposed rules and regulations to be issued by the authorities are circulated well in advance for comment, assuring transparency. The branches of foreign banks and/or their Austrian subsidiaries have been allocated a seat in the Bankers' Association, which rotates among members. (Deutche Bank has it own seat.) According to some press reports, fee structures and administrative charges are set in an informal cartel-like arrangement by the dominant Austrian banks in the association, with little or no vetting among members.

OTHER EU AND EFTA — FINLAND

RECENT DEVELOPMENTS

Finnish financial services liberalization has been conducted both independently and in the context of EEA implementation. In the late 1980s, Finland removed capital controls and deregulated interest rates. In 1991, it removed restrictions on foreign branch banking. At the beginning of 1993, in anticipation of the EEA taking effect, Finland implemented a law removing previous restrictions on foreign ownership in Finnish companies, including providers of financial services. For a three-year transition period ending on January 1, 1996, the government will screen foreign investments involving a third or more of the stock of the approximately 100 largest companies. The government has pledged that only in extreme circumstances would a foreign takeover be blocked, and since the law went into effect, the government has not stepped in and blocked a takeover. Companion legislation involving financial institutions only, which also went into effect at the beginning of 1993, provides that all investors, foreign and domestic, are required to inform financial supervisory authorities when their ownership share exceeds 10 percent or rises by increments of 10 percent or more. Investors must meet managerial and capital requirements as specified in European Union Directives.

TREATMENT OF FOREIGN INSTITUTIONS

The establishment of financial institutions in Finland by foreign or domestic parties requires a license, the procedure for which is in line with that specified in relevant EU directives. According to Bank of Finland officials, the intent of all financial liberalization has been that it should be on an erga omnes basis. The principal area in which Finland makes a distinction between financial institutions based in the EEA and those outside concerns establishment of branches of financial institutions. EEA-based institutions can be automatically established; those from third countries require separate clearance regarding a country's prudential requirements. Finnish officials state that in practice U.S.-based institutions would be treated as those from EEA countries, since U.S. prudential practices are well and favorably known.

OTHER EU AND EFTA — FRANCE

SUMMARY

The French government is up-to-date in implementing EU Financial Services Directives. Regulations implementing the Large Risks Directive were put into place in December 1993 and changes in laws and regulations to implement the Consolidated Supervision Directive have been made. The two directives that the French are in the process of implementing are the Capital Adequacy Directive and the Investment Services Directive. French government officials have said that timely, uniform implementation of EU directives is an important goal, and they have played a strong role within the EU in the establishment of technical groups to discuss EU-wide implementation of directives.

EU DIRECTIVES

Implementation Process

Within the government, the Minister of the Economy, and specifically the French Treasury, has lead responsibility for implementation of EU directives. However, other entities, in particular the Bank of France, are closely involved. (Chief responsibility for drafting banking regulations lies with the Banking Regulatory Committee, which is chaired by the Minister of the Economy, but whose staff comes from the Bank of France.) The French implementation process can consist of changes of regulations and/or changes in law, depending upon the extent of changes needed.

Several U.S. financial institutions have expressed concerns regarding limits to their ability to participate in the implementation process. Part of the problem lies with the strong role played by large French banks, and the close relationship many French bankers have with government officials. (Many bankers come from the government sector.) The government seeks advice and comments from banks on the Financial Services Directives via the French Banking Association, where foreign banks have only limited influence. Future implementation of additional directives (see below) will be very important for U.S. institutions, and those institutions are seeking ways to increase their input in the implementation process. French authorities say they are aware of the interest of U.S. and other foreign banks in participating in the implementation process, and that they encourage such entities to seek a larger role, including at the level of preparation of EU directives.

Impact of EU Directives Implementation

There are no reported serious problems that U.S. financial institutions have encountered as a result of the implementation of EU Financial Services Directives. However, there are some potential problems. One area of concern is the provision of cross-border services, where there appears to be uncertainty, in France and elsewhere, regarding how the EU directives should be implemented. The French have made clear their preference that if services are provided on a regular basis, this should be done from within France and not through the provision of cross-border services. Another area that U.S. banks will look at carefully is the way in which France and other EU countries will tax financial institutions, particularly in areas where it is not clear who has taxation authority. Finally, there is interest in how the French will use their ability under the directives to take actions in the "national interest" or "general good."

U.S. financial institutions say that some aspects of the Second Banking Directive have facilitated their European operations. However, the strong powers of the implementing authorities and uncertainty regarding how these authorities will enforce some of their regulations have made some U.S. banks cautious in using some of the provisions of the financial directives already in force.

An area to be monitored in the future is the reciprocity provision that the French intend to insert into implementing regulations that involve authorization for branches of institutions based in non-EU countries. The newly (December 1993) implemented regulations for the Large Risks Directive is the first to contain such a clause. (Previous French large risk regulations did not contain this element.) The concept is contained in a more general form in the Second Banking Directive, however.

The relevant clause in the large risks implementing regulations states that branches of non-EU banks will be deemed to be in compliance with these regulations if the French Banking Commission verifies that three conditions are met: (1) the regulations in the branch's home country are as strict as those in France; (2) the head office has ensured that its branch is being supervised by the competent authorities according to the rules in effect in the home country, is in conformity with home country rules and that the branch has sufficient funds to cover its activities; and (3) French credit institutions (etablissements de credit) benefit from treatment in the home country in the area covered by this directive that is equivalent to that accorded to branches that are requesting the benefits of this clause. There are no written explanations as to how the French authorities will determine whether equivalent treatment exists. It appears that they will examine the relevant legislation of the third country involved, and perhaps also canvass French institutions in that country. French authorities have said they have not determined whether "mirror image" or "national treatment" will be the criterion for implementing this clause. A "mirror image" reciprocity test could cause problems, especially if the approach is adopted in the implementing legislation for other directives. However, we have no indications at this time that this will be a problem for branches of U.S. banks in France. It appears that this

is mainly a tool to be used, as necessary, against non-EU countries that maintain serious restrictions on French financial institutions.

Future Directives

U.S. institutions are closely following the process of implementing new EU directives. Of particular interest is the implementation of the Investment Services Directive. Although the French are in the initial stage of thinking about its implementation, there are indications that this process could lead to fairly major changes in the French financial system. For example, there is an ongoing internal debate within the government and among relevant bodies regarding the possibility of revising supervisory responsibilities over nonbank financial entities in France. Also, there is interest in whether the government will address, on the occasion of the implementation of the Investment Services Directive, the current inability of non-French financial entities to lead-manage corporated including state-owned, French franc nongovernment domestic bond issues. Implementation of the Capital Adequacy Directive also will be important, particularly given that some aspects of this directive are not completely clear.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

While it is difficult to sum up the general attitude of U.S. financial firms in France, many of whom have different goals and philosophies, it appears that on the whole they feel they receive fairly good treatment. It would appear that national treatment is for the most part granted to U.S. entities in France. The situation has improved steadily since the reforms of the financial system in the late 1980s. The French authorities are committed to building up Paris as a major international financial center, and have, wherever possible, encouraged the entry of internationally recognized foreign financial entities, and the development of new financial instruments in France. However, the market could benefit from greater transparency, in the way in which French authorities enforce their law and regulations in some areas, and a simpler structure for obtaining approvals. This applies mainly to areas where there is competition from large French banks, such as the system of primary dealers for government bond issues, and in the privatization process.

A specific area where U.S. institutions, as well as other non-French financial institutions, seek better treatment is in the bond market. Only French banks are allowed to lead-manage domestic nongovernment (private and public sector companies) French franc bond issues, and authorization is required to lead-manage Eurofranc issues. Foreign banks have also complained in the past about the deposit guarantee system (run by the French Banking Association as an ex-post bailout rather than a premium-based insurance program) used in the case of bank failures. A new system was recently agreed to that generally satisfies foreign banks. (Under a previous plan, foreign banks as well as some of the smaller French banks felt they were being asked to pay too large a share of the costs when a French bank failed.)

U.S. banks also have complained that they have played only a small role so far in the privatization process begun in 1993. French banks have played the dominant role as advisors to the government and privatized companies and as lead managers of the share issuance process in France.

Most of the problems noted above are encountered by almost all other non-French banks. We know of no documented case where U.S. banks are singled out for discriminatory treatment.

PRESENCE OF FOREIGN FIRMS

Of the total of 425 banks in France as of end-1993, 180 were non-French banks, 83 were from other EU countries and 24 were from the United States. Counting financial establishments more broadly, including securities firms, investment banks, etc., there were a total of 1,674 institutions at the end of 1993, including 293 non-French establishments, 156 from other EU countries, and 39 from the United States. In 1993, foreign financial institutions accounted for 8.6 percent of total assets and 3.8 percent of total lending in France.

OTHER EU AND EFTA — GERMANY (BANKING)

SUMMARY

Germany's legal structure for banking, the Germany Banking Law (Kreditwesengesetz, or KWG), provides for nondiscriminatory treatment for foreign bank subsidiaries and branches. Legally, the German banking industry is comparatively open to foreign participation. As of February 1994, some 4,000 banks were operating in Germany, of which about 150 were of foreign origin. About one-third of foreign banks were established as branches. A rough market share figure for foreign banks is about 5 percent in terms of assets. This includes purely investment banks, which are all foreign, since Germany does not differentiate between bank and securities activities.

As a result of the European Union, German banking law has undergone substantial revision over the last four years. Although these changes have liberalized the German banking system a great deal, minor discriminations against foreign bank branches and subsidiaries have arisen as a by-product of the implementation of the EU Banking and Securities Directives. However, both U.S. and German authorities have shown an exceptional willingness to cooperate and deal with these issues as they have arisen.

REGULATION

Fourth Banking Reform

The main development in the German banking system since 1990 has been the Fourth Reform of the German Banking Law. This law created new definitions for capital, liberalized rules governing branch banking, and introduced stricter rules regarding owner control. It implemented the EU Second Banking Directive and the Own Funds Directive, and the EU Solvency Ratio Directive, effective as of January 1, 1993.

The EU Second Banking Directive allowed banks incorporated in other EU countries to operate branches in Germany on the basis of the banking license granted by their home country's supervisory authorities (i.e., "the single passport"). Unfortunately, it created a legal differentiation between third country bank branches and EU bank branches. Supervision and regulation of EU bank branches were returned to the home country, while non-EU branches continued to be supervised by the German authorities. These branches thus remained subject to a minimum dotation (local or endowment) capital requirement, as well as credit limits, single large borrower limits, and capital adequacy ratios based on their dotation capital in Germany, while branches of EU banks did not have such restrictions.

The dotation capital requirements for non-EU country bank branches in Germany are quite costly primarily because they require the branches to maintain substantial amounts of capital in order to meet lending and other operational ratios. Since the business structure of these branches is not equally spread over all these exposure areas, the level of capital has to accommodate the

maximum single exposure (e.g., foreign exchange, large credit, interest rate or risk assets). The dotation capital of foreign bank branches in Germany is typically very high; at the end of 1992, it accounted for about 7 percent of total assets.

Dotation capital is also subject to a 1.5 percent net worth tax on an annual basis, and because these taxes are not fully deductible for income tax purposes, the dotation capital also has a secondary income tax effect. In addition, interest payments on dotation capital are not deductible for tax purposes. Furthermore, injection of dotation capital is subject to time-consuming and costly registration procedures and reporting requirements.

Partially as a result of encouragement from foreign banks and foreign authorities (including the U.S.), the German authorities included in the Fourth Banking Reform Legislation a provision for bilateral agreements with non-EU countries to grant exemptions from the dotation capital requirements to third country foreign banks meeting certain requirements. Under these agreements, the EU privileges would apply wholly or partly, provided the country grants national treatment to German banks, exercises bank supervision according to international standards, and its supervisors cooperate with German supervising authorities through a bilateral agreement (Section 53c of the German Banking Act).

In early 1993, the U.S. and German authorities entered into discussions to reach such an understanding. Agreement was reached in February 1994; on May 3, 1994, the German Finance Ministry issued a decree that broke the link between dotation capital and the various operating ratios for U.S. bank branches. While the minimum dotation capital requirement remained in place, large credit exposures would be evaluated based on the capital of the parent institution. U.S. bank branches were exempted from other credit exposure and capital adequacy ratios.

The Fourth Banking Reform also implemented the EU Own Funds Directive to set definitions and standards of capital requirements for credit. The new definition is a minimum capital requirement of EU 5 million (about DM 10 million, or $7 million) for an individual bank. It also allows expansion of the admissible second tier capital base by including revaluation reserves and subordinated loans. Finally, notification rules were established for shareholders and banks for acquisition and extension of share capital. The EU Solvency Ratio Directive was implemented with new standards for risk-adjusted assets, and off-balance sheet items, with a new minimum solvency ratio of 8 percent.

Other Banking Reforms

After the Fourth Banking Reform, the next piece of major legislation was the German Money Laundering Law which, implemented the EU Money Laundering Directive, effective January 1, 1993. This law established a DM 20,000 floor for recording transactions, and standards for reporting suspicious financial transactions. Banks are required to establish identification files and keep them for six years.

The German Commercial Trade Act implemented the EU Annual Accounts and Consolidated Accounts Directive and became effective also on January 1, 1993. This law sets rules on preparation, publication and audit of annual accounts and consolidated accounts by banks and other financial institutions.

The Fifth Banking Reform was passed during the summer 1994, to be implemented on January 1, 1995. This reform implements the EU Consolidated Supervision Directive and the EU Large Exposure Directive.

The Consolidated Supervision Directive aims at "financial group" supervision of credit institutions for the purposes of risk and large exposure. However, some disadvantages may arise for foreign subsidiaries. Consolidated supervision will include subsidiaries operating in Germany, many of which are held indirectly by a German holding company which borrows from the parent company. (This structure is used, rather than direct holding of equity in the subsidiary by the parent itself, to avoid dividend compensation). The consolidated supervision will require that the capital of the subsidiary and the holding company be added, and the book value of the shares in the subsidiary be deducted, leaving only (more or less) the thin capital base of the holding company for the purpose of determining risk and large exposures. This will severely curtail the activities of the subsidiary.

However, German consolidated supervision will not apply to financial groups owned by a credit institution in another EU country. Again, a proviso is included in the legislation to grant similar treatment to third country subsidiaries if reciprocity is observed in the banks' home country. The method described by German law for non-EU countries seeking such treatment requires, as a first step, negotiations with the EU Commission be held by third countries with respect to supervision on a consolidated basis. After an EU/third country agreement is reached, regulators on both sides will work out a cooperative plan for adequate supervision of the group. Once that is accomplished, then that country's financial groups operating in Germany will be exempted from German consolidation supervision requirements. U.S. banks in Germany are anxious to see such negotiation commence. (It should be noted, however, that this legislation pertains only to commercial banks, not to securities firms. Such legislation might be extended to securities firms in the implementation of the EU Capital Adequacy Directive or the rest of the Investment Services Directive.)

The Large Exposure Directive will extend the definition of loans to comprise assets and off-balance sheet items, proprietary positions in financial instruments, and transactions in derivative instruments and foreign exchange futures. On a consolidated supervisory basis, as well as a single bank basis, large exposures are anything over 15 percent of the bank's own funds. The limit for a single exposure of a bank will be lowered to 25 percent on January 1, 1999. Total large exposure may not exceed 800 percent of own funds.

A Sixth Reform of the German Banking Act already is contemplated. It will, among other things, implement the EU Capital Adequacy Directive. Enactment is expected in 1995 and implementation perhaps in January 1996. Thus, foreign-owned investment houses in Germany will have an interim period of disadvantage relative to German banks participating in securities trading.

One outstanding issue is that of data processing. Foreign banks in Germany are eager to have the ability to send records back to the parent company for processing. For the time being, German bank regulators do not permit data processing outside the EU. U.S. regulators have met with German officials to see what can be done on this issue, and some agreement on the issue is anticipated around the end of 1994.

Another concern is the resistance of supervisory authorities to the introductioin of internationally established financial innovations that are not technically illegal in Germany. One example is asset-backed securities (through a special financing company, a bank refinances accounts receivable by selling bonds or stocks), which regulators have actively discouraged on prudential grounds, expressing concern that banks might sell off good assets and keep bad assets.

Relevant Tax Legislation

Germany also has in recent years implemented two new tax laws that have affected the banking industry. The first, implemented January 1, 1993, established a 30 percent automatic withholding tax for interest income from bonds and bank deposits. This resulted in a great deal of capital flight to Luxembourg, Switzerland, and Austria. The Tax Reform Act of 1993, implemented on January 1, 1994, reduced corporate tax rates, tightened rules on dividend stripping, and extended the income tax to all interest earnings coming from foreign sources. The main effect of the legislation is the inclusion of income taxation on innovative financial instruments, which was heretofore governed only by decree. In addition, new rules for thin capitalization were introduced that could be interpreted to severely limit use of funds picked up by the German subsidiary from the non-EU parent (allowable up to 30 percent of a direct subsidiary's assets and 90 percent of the assets of a subsidiary established through a German holding company). The Association of Foreign Banks has been working with German authorities to interpret this passage in such a way to allow for broader usage of these funds. Some agreement in the near future is expected.

The securities market in Germany has developed rapidly over the past decade. A number of institutional, tax, and other developments have led to distinct changes for German stock markets. Trading became largely automated with the institution in 1990 of an automatic exchange system, the IBIS (Internationales Boersen Informationssystem). Also in 1990, Germany created an exchange for options and futures trading, the DTB (Deutsche Terminboerse), which quickly rose to become continental Europe's largest stock options market and its second largest futures market. Securities are traded in nine regional exchanges, but trading is becoming increasingly concentrated in Frankfurt, which now handles about 70 percent of the market (as opposed to about 40 percent in 1985). By 1992, Frankfurt had become the third largest exchange in the world in terms of market value turnover.

Securities Reforms and Market Promotion

Several reforms affecting the securities markets have been implemented in recent years with the intention of eliminating unnecessary and outdated disincentives to further development of securities trading. The First Financial Market Promotion Law became effective on March 1, 1990, several months prior to German unification. This law abolished the securities transactions tax (Boersenumsatzseuer, retroactively effective to January 1, 1991), the one percent tax on all new and supplemental shares issued by a company (Gesellschaftssteuer, retroactively effective to January 1, 1992), and stamp taxes on bills of exchange transactions (Wechselsteuer, retroactive to January 1, 1992).

The first promotion law also implemented the EU directives harmonizing rules for authorization, supervision, and structure of mutual funds except pure money market funds, which have subsequently been dealt with in the Second Financial Market Promotion Law.

The Second Financial Market Promotion Law was passed in July 1994 and took effect on August 1, 1994. The legislation sets up a federal regulatory and oversight structure for securities trading, which has been heretofore loosely regulated (largely self-regulated) at the state level. The new structure will become effective January 1, 1995. The legislation also implements the EU's Insider Trading Directive, the Public Disclosure Directive, and partially implements the Investment Services Directive.

For securities oversight the legislation establishes a new Federal Securities Supervisory Office (Bundesaufsichtsamt fuer Wertpapierhandel — BAWE), to begin operating on January 1, 1995. This will be an independent federal office associated with the Finance Ministry, and will be charged with overall responsibility for supervising the securities industry. The BAWE will be financed 75 percent by banks and investment firms, 10 percent by commercial bond and stock issuers, 10 percent by the government, and 5 percent by independent brokers or traders. The states, regional stock exchanges, the Bundesbank and the BAK will assist the BAWE in market

supervision and information collection. The law also establishes a new securities council (Wertpapierrat) composed of representatives of state and federal governments, BAK authorities, and Bundesbank representatives, to advise the BAWE on regulations and oversight. It should be noted that the BAK will continue to supervise the banking activities and overall balance sheets of firms participating in securities trading. Foreign-owned investment houses will likely continue to be required to seek licensing from the BAK.

The BAWE will be charged with enforcing the new regulations on trade in securities and derivatives also contained in the legislation. These regulations cover all aspects of transparency, participation, insider trading, and business conduct of securities firms (including banks and nonbanks). The law sets fines on the violation of any of its provisions, and revises and clarifies responsibilities of regulators on the state and local levels. The legislation includes provisions to make insider trading a criminal offense. The legislation defines insider information as any nonpublic information relevant to a security that, if made public, would have a significant impact on the price of that security. The law makes use of this information by either "primary" or "secondary" insiders (individuals whose information originated from a primary insider) a criminal offense. Also, legislation establishes notification requirements for purchases and sales of over five percent of the voting shares of an exchange-listed company, making this a less opaque and suspicious process. This is stricter than the EU directive, which only requires notification for transactions of over 10 percent of voting shares.

The Second Financial Market Promotion Act also contains regulations on the behavior of investment services firms. In addition to "general" behavior rules, the law stipulates "special" behavior rules that require, for example, that investment services firms may not trade on their own account in securities or derivatives if they have issued recommendations to buy or sell such securities, nor may they conduct their "own account" business before customer account business (front running). The legislation also amends the Investment Company Act to allow unit trust funds to lend part of the securities they administer and widens the set of assets the investment funds may hold, including futures and options. The act also revised the rules on investment funds to allow pure money market funds (effective as of August 1, 1994). Until now investment funds in Germany were limited to 49 percent or less of the fund's total assets in short-term instruments.

The legislation contains a number of other minor amendments to existing securities market regulations, for example, lowering the minimum par value for shares to DM 5 from the previous DM 50, allowing banks to trade in their own shares, and allowing securities held in custody to be lent without explicit authorization by the owner (business only, not private). The legislation took a long time to prepare, in part because lengthy negotiations were required before the states were inclined to cede constitutionally granted authority in order to clear the way for the federal government to establish a regulatory agency for securities trading. There were also differences within the private financial sector regarding the extent and nature of the proposed reform.

The banking industry and stock exchanges have welcomed the broad aims of the pending securities legislation but have sought numerous changes. Most of these changes are sought by the banking industry as a whole, but some have particular resonance for the foreign banks. For instance, the foreign banks have maintained that the powers of the BAWE will be diluted by responsibilities still designated to the states. Their suggestion that the BAWE should be empowered to set up a code of conduct for market participants was accepted and actually adopted in the final version of the bill.

Treatment of Foreign Institutions

The foreign banks generally have few complaints with their treatment vis-a-vis the German banks. One remaining EU discrimination, however, is that non-EU bank branches in Germany cannot participate in the safe custody business. If branch banking becomes more important for U.S. banks (as a consequence of implementation of section 53C regulations waiving dotation capital requirements — see below), some may be interested in participating in the investment funds business. Their exclusion from becoming safe custody banks and carrying out stock orders is discriminatory relative to German banks and bank branches from other EU countries. A practical example of this arose recently when a U.S. institution heavily involved in the investment funds business invested in Germany and was obliged to establish a subsidiary (with all the resulting expenses) instead of a bank branch in order to be able to carry out its business. German Finance Ministry officials point out that they are bound by European Union legislation (UCITS Directive). The issue is being taken up with Brussels, and some type of resolution is expected next year.

Finally, the Foreign Banks Association in Germany will be lobbying in the second half of 1994 for what it hopes will become incorporated in the German legislation to implement the rest of the EU Investment Services Directive. Specifically, U.S. investment firms in Germany are interested in obtaining the equivalent of an "EU passport" for investment firms, a legal standing similar to that provided to U.S. banks under the auspices of Section 53C, providing (wholly or partly) equal treatment as provided to branches of European investment firms. The U.S. firms would be free to operate without dotation capital requirements and without local capital-related restrictions, rights currently enjoyed only by European credit institutions.

Background on Securities Markets

These efforts of the corporate and banking communities to promote the growth of the German securities markets are faced with one particular structural feature of German securities market that could be somewhat resistant to change: an unwillingness to shift from the traditional reliance on internally generated profits and debt financing to increased use of equity financing in the German corporate sector.

The securities market in Germany is characterized by a relatively weak equity market (30 percent) compared to the bond market. The trading of equities is concentrated mainly among the largest German companies, while the majority of German businesses, which are small to medium sized, choose to stay out.

The reasons for this weak equity market are many:

- Participation is difficult: only firms organized as stock corporations (about 3,000 of the 50,000 firms registered in Germany) are eligible to be listed. Only 754 firms are actually listed, and even among these turnover is minimal. The top 30 firms on the DAX account for 76 percent of the market. Listing costs are quite high, sometimes approaching 5 to 9 percent of each share. Flexibility in offering an issuing is limited; each issue of equity requires a 75 percent approval by existing shareholders. Moreover, shareholders have preemptive rights to buy shares at below-market prices, so many new issues never make it to the market.

- The traditional corporate-bank relationship discourages equity financing: German firms tend to rely on one bank for all financial needs, thereby giving a bias to debt financing as opposed to other means. In the 1987-90 period, funds raised by share issues were less than 8 percent of all funds from external sources, and less than 3 percent of total funds. The percentage rose in 1991 and 1992, but mainly due to the decline in new enterprise debt rather than an increase in share issuance.

- Corporate Germany is quite conservative: most German businesses are small or medium-sized, family owned firms, with built-in suspicions against outside ownership.

- The demand side is weak: The federal pension system is "pay as you go" and does not invest much in securities. Issuers have recourse to broad use of voting rights restrictions for new investors. The disclosure requirements in Germany are not particularly rigorous and diminish investor confidence. Finally, the small investor is discouraged by the steep nominal prices of equities, heretofore a minimum of DM 50 per share. Furthermore, the securities industry is grappling with politically difficult structural changes: the move toward centralizing trading in Frankfurt and away from the regional exchanges and the increasing redundancy of floor trading with the advent of automation. Observers have noted that these constraints could keep Germany from becoming a net exporter of investment services in the near future, but they hope that recent and prospective financial market promotion rules will allow Germany to keep pace with its main competition in London and Paris.

OTHER EU AND EFTA — NETHERLANDS

SUMMARY

According to the Ministry of Finance, Dutch legislation fully implements all existing European Union law and regulations on the provision of financial services. In practice, Dutch, EU, and branches of non-EU institutions must fulfill the same criteria for obtaining an operating license and foreign providers face no special conditions or restrictions. However, applications of institutions from non-EU countries are subject to a reciprocity test and the number of licenses granted to credit institutions from on country (non-EU) can be limited. Rules applied in the regulation of non-EEA branches are at the discretion of the Dutch authorities.

IMPLEMENTATION OF SINGLE MARKET DIRECTIVES

The Act on the Supervision of the Credit System of December 1992, Staatsblad 772 implemented EU directive 89/646/EEC and Council Directive 92/30/EEC. In April 1994, the Dutch parliament passed a law on the supervision of financial conglomerates, ahead of a planned EU directive on the subject. Existing Dutch legislation on a deposit guarantee system is being used as the model for the proposed EU directive, the only real difference being that Brussels wants to grant protection to legal as well as natural persons (the Dutch scheme applies only to natural persons).

Reciprocity

One provision of the 1992 Act does, however, reflect the EU Banking Directive's "reciprocity" provision. Chapter XI, section 81, provides that: "also in implementation of decisions taken pursuant to the provisions regarding relations to third countries contained in the Second Directive, our (finance) minister may decide that: a) notwithstanding the provisions of Sections 8 and 9, decisions in respect of applications for authorizations referred to in Section 6 submitted by subsidiaries of enterprises or institutions established in a certain state not being a member state shall be suspended by the bank for a certain period, with corresponding suspension of the period as referred to in section 8(3), or that the bank shall not grant more than a number, to be specified by our minister, of authorizations as referred to in section 6 applied for by subsidiaries of enterprises or institutions established in a certain state not being a member state..."

Paragraph b of the same section applies identical wording to applications for a "declaration of no objection" from the central bank for the purchase of an equity stake by a non-EU enterprise in a Dutch financial services provider, or by a non-EU financial services provider in a Dutch enterprise. The Finance Ministry says that this ministerial power has never been used, and all non-member applications are processed by the bank on a nondiscriminatory basis. Moreover, all foreign branches, once established, including those from Japan and other Asian countries, are treated the same as domestic banks.

U.S. banks and securities firms are allowed to engage in mutual fund management activities. There are no restrictions on foreign securities firms or banks managing pension fund or other institutional monies.

The Finance Ministry also says Dutch law is fully consistent with the new GATT agreement, and there are no plans to change aspects of legislation when the Netherlands accedes to the Uruguay Round Agreement

PRESENCE OF FOREIGN INSTITUTIONS

Foreign banks have made little headway in the Dutch banking sector. The sector is dominated by three giant Dutch banks — ABN Amro, Rabo Bank, and ING Bank — which have about 75 percent of total lending. Smaller Dutch banks take another 20 percent of the market. Although ABN Amro is the largest foreign bank in the U.S., no U.S.-owned bank makes the top 30 list of banks in the Netherlands.

This is not the result of de jure discrimination, but of market structure and conservative Dutch business practices. Common directorships among Dutch banks and, it has been alleged, tacit understandings to share the market, combined with a Dutch reluctance to break long-standing business relationships, limit the market penetration of U.S. and other foreign banks.

TREATMENT OF U.S. FIRMS

Citibank and the Foreign Bankers' Association say they have "no complaints," and confirm that the Finance Ministry and Central Bank grant them full national treatment. They note that Dutch banks may have better contacts within the Central Bank and Finance Ministry, but they receive no noticeably better treatment as a result. They know of no instance of section 81 of the 1992 act being used, and note that "the Netherlands is an open economy and an easy place for foreigners to operate in."

Because U.S. banks organized in the Netherlands as branches cannot benefit from the EU single banking passport, they are subject to Dutch regulation. Non-Dutch EU banks, to which the single passport applies, are subject only to the regulation of their home states. Thus, U.S. branches would be at a competitive disadvantage if Dutch domestic regulations were stricter than elsewhere in the EU. This may be more hypothetical than likely.

OTHER EU AND EFTA — NORWAY

SUMMARY

Prior to the European Economic Area (EEA) Accord, which took effect January 1, 1994, Norwegian regulators issued licenses that allowed foreign financial institutions to establish in Norway as subsidiaries or representational offices. Foreign financial institutions were not allowed to enter as branches. Under this regime, several American banks set up subsidiaries to service the needs of their business clients, i.e., the offshore oil industry.

In anticipation of the EEA Accord, the Norwegian parliament acted in 1993 to adopt various EU banking edicts, including the EU Second Banking Directive. Its adoption opened the Norwegian market to branches of banks incorporated in any EEA member state. This includes subsidiaries of U.S. banks. However, Norway retains its own rules for reviewing applications of financial institutions from non-EEA member states to establish direct branches. Currently, such branching is prohibited. However, Norwegian officials have indicted that the prohibition will be lifted.

According to a Ministry of Finance official, Norwegian law subjects third countries to reciprocity requirements. Before approving a third country financial institution's application to establish in Norway, Norwegian authorities must examine the third country applicant's home country financial services investment regime. The Foreign Ministry's "white paper number 100" on the results of the EEA Accord, which was presented to the Parliament on May 15, 1992, spells out the Finance Ministry's explanation. Unofficially translated, it reads:

> "...In many instances there would be little reason to practice a different policy for third countries. For these cases, consultations and cooperation to evaluate a third country's policies are arranged. Problems would arise in cases where the actual market access in a third country is worse for one or more EFTA countries compared with the EU."

TREATMENT OF FOREIGN FINANCIAL INSTITUTIONS

Under the EEA Accord, Norway has less than two years — until January 1, 1996 — to liberalize its restrictions on foreign investment in the financial sector. However, the liberalized investment regime will apply to EEA member countries only, thus putting investors from non-EEA member countries, such as the United States, in an unfavorable position. According to Ministry of Finance officials, the continuing financial services market access negotiations for GATT, which will continue during the first six months that the agreement is in effect (July 1 to December 31, 1995), may provide an avenue for Norway to address its two-tier investment regime.

Banks and finance companies

No single or organized group of investors may acquire or hold more than 10 percent of the share capital in an existing Norwegian commercial bank or finance company, or more than 10 percent of the primary capital of a savings bank. This does not apply to a bank or to a finance company that forms a part of a financial group. The Ministry of Finance may in special cases grant exemptions from this limitation on single investor ownership in these institutions, but practice remains restrictive. In order to establish subsidiaries of foreign banks in Norway, an exemption to the single investor rule exists. One or more foreign banks may be permitted to establish a new Norwegian commercial bank if a single foreign bank owns more than 50 percent of the share capital in the new bank. Subsidiaries of foreign banks are governed by the same capital requirements as Norwegian-owned banks. A foreign finance company may also establish a subsidiary in Norway.

Establishment in Norway of branches of banks/finance companies from outside the EEA is not permitted. However, the government plans to submit legislation to Parliament that would eliminate the prohibition as of January 1, 1995. Foreign bank applications would be approved subject to the meeting of a prudential test and fulfillment of capital requirements. (Further details were not available as of mid-September 1994.)

Brokerage, Collective Investment Funds, Fund Management

No single or organized group of foreign investors may acquire or hold more than 10 percent of the share capital in a new or existing Norwegian brokerage firm or management company to a collective investment fund. The Finance Ministry may grant exemptions of up to 25 percent of the share capital.

A foreign brokerage firm or a management company to collective investment funds is not permitted to establish a subsidiary in Norway. These restrictions will be abolished by January 1, 1995, as will the ban on establishment of branches in Norway of a foreign brokerage firm or management company to collective investment funds.

However, currently, foreign commercial banks established in Norway may establish a brokerage firm or a management company to collective investment funds in Norway, and may also engage in brokerage services through the subsidiary itself.

Only foreign brokerage firms incorporated within the EEA may underwrite equity and bond issues. No limitations exist as to foreign brokerage firms trading on own account in securities traded in Norway (except for special requirements in mining, energy, fisheries, transportation and broadcasting).
Only brokerage firms established in Norway may have access to seats on the Oslo stock exchange and may act as account operators in the Norwegian Registry of Securities. Under

current law, foreign brokers are restricted from branching in Norway. The EEA Accord requires Norway to liberalize its regulations on brokerage activities by January 1, 1996.

Only management companies incorporated in the EEA may market units of collective investment funds to the Norwegian public. Due to prudential reasons, management of pension funds portfolio investment may be handled only by EEA credit institutions and brokerage firms.

Trading in derivatives, including options and futures, is subject to the same regulations that apply to securities trading.

Capital Movements

Norwegian residents have, subject to a notification requirement, free access to financial instruments offered abroad by nonresidents with the exception of securities not normally traded in an EEA state or in a state with equivalent prudential requirements that continue to be reserved for resident firms. The limitation applies only to secondary market trading and not to primary issues and direct investment abroad. Similar rules apply to insurance services. Brokerage of securities issued abroad may take place subject to Norwegian marketing rules.

Transparency

All regulatory amendments are normally notified by the Norwegian Banking, Insurance and Securities Commission to financial and other relevant institutions established in Norway. Some foreign financial institutions have expressed concern about existing and prospective screening mechanism, lack of transparency, and discrimination related to Norway's EEA membership and prospective membership in the EU.

OTHER EU AND EFTA — SWEDEN

SUMMARY

All four forms of market entry are permitted in Sweden: subsidiaries, branches, acquisitions, and cross-border trade. (Because of recent revisions in tax law, many establishments of foreign-owned banks may now change from being subsidiaries to branches.) Since early 1994, Swedish government officials have actively encouraged foreigners to acquire one or more Swedish banks. So far, however, there have been no takers. The Swedish securities market is also being rapidly transformed from virtually a closed market to one with a great degree of openness under EEA rules.

DESCRIPTION OF THE MARKET

Prior to 1980, the Swedish financial services sector was tightly restricted and walled-off from direct foreign participation by a series of laws and regulations, including a legacy of foreign exchange controls dating back to World War II. The process of deregulation in Sweden, as elsewhere, gained momentum during the 1980s, with decontrol of the credit market and acceptance of foreign financial service provider presence by mid-decade. Essentially, there were three "waves" of liberalization in this process. The first was characterized by a new awareness among the Swedish authorities to barriers sheltering domestic markets, perhaps triggered by the EC White Book on the Internal Market in 1985. Significant internal and external deregulation then began to occur. The second wave was characterized by a decision in 1988 to give regard to EC standards in future legislative actions, including in the financial services sector. Currently, in the third wave, Sweden is continuing to adapt its legislation governing financial services to EEA law and practice.

Benchmarks in the opening of the Swedish financial services sector:

1985	Foreign-owned banks allowed to establish subsidiaries in Sweden.
1987	The Swedish market for stocks and index bonds is opened to nonresidents.
1989	Exchange regulations virtually abolished.
1990	Foreign-owned banks allowed to open branches in Sweden.
1990	Foreign ownership permitted in Swedish banks and other credit institutions.
1991	Foreign-owned companies, subject to approval, allowed to conduct finance company operations and securities operations through branches in Sweden.

1993 Foreign Ownership Restriction Clauses abolished. All corporate shares listed on the Stockholm Stock Exchange may be acquired by Swedes and foreigners alike. (Shares can still have differing voting strengths, however).

Implications of the EEA Accord

In anticipation of the establishment of the European Economic Area (EEA), the Swedish Parliament has adopted and/or amended legislation to reflect obligations which come into being under that arrangement. Provisions of the EU's Second Banking Directive regarding free cross-border trade in financial services, freedom to establish credit institutions in all EEA countries, mutual recognition of regulatory regimes, and a set of minimum supervisory and prudential rules now apply. The main exception is in regard to relations with third countries, where Sweden currently does not apply EU reciprocity requirements.

According to Swedish authorities, the intent of all financial sector liberalization — undertaken unilaterally or in conformance with EU/EEA law — is that it be extended on an erga omnes basis. In this regard, Sweden is particularly conscious of its obligations under the OECD Capital Movements Code. Prior to entry into force of the EEA agreement, Sweden confirmed to the OECD that it did not intend to restrict the establishment of foreign financial institutions, in general, after the EEA came into being. Sweden also announced that it intended to apply any liberalization of capital movements required by the EEA Agreement erga omnes. Sweden, alone among the EFTA countries, has no reciprocity entries under Annex E of the OECD Code of Capital Movements.

Under the EEA, and certainly as an eventual EU member, Sweden is obliged to introduce all aspects of the Second Banking Directive, including those pertaining to reciprocity requirements. It has not done so up to now, however, because of the government's understanding that the European Union's reciprocity requirements might be done away with in the context of continuing GATT financial services negotiations.

TREATMENT OF U.S. INSTITUTIONS

Under EEA and Second Banking Directive obligations, Sweden cedes financial institution control and regulation to EEA "home countries," but retains its own rules for reviewing applications from non-EEA member states such as the United States. In practice, U.S. financial institution applicants would have no difficulty in entering the Swedish market; Finance Ministry officials say there are only small, technical differences (apart from the reciprocity requirement) between Swedish procedures for establishment and those obtaining in EU countries. Upon establishment, a U.S. financial institution would find itself under Swedish national supervision and would be subject to the same rules and regulations as are indigenous institutions.

OTHER EU AND EFTA — SWITZERLAND

SUMMARY

There are no legal constraints on the establishment or operations of foreign financial firms. There are no constraints faced by foreign banks with regard to funding their business activities. Foreign securities firms have the opportunity to broker, deal, and underwrite on the same basis as domestic firms. Foreign firms can obtain seats on the stock exchanges. There are no impediments to the introduction of new financial products. Foreign banks can offer structured products and securitized products. No constraints on maturity structures exist. Switzerland has one of the most liberal regimes regarding fund management activities. No discrimination against foreign funds exists. Management of local pension funds and other institutional monies by foreign banks is permitted. There are no limitations on investment by foreigners in local equity and debt instruments. They can invest directly, and foreign shareholders in domestic companies are not limited by law. Since 1990, corporate law regarding registration of foreign shareholding has been liberalized. Residents can freely access financial instruments offshore and are not subjected to capital controls. Some reporting requirements exist for both domestic and foreign residents.

RECENT DEVELOPMENTS

Stamp Tax Reform

In April 1993, a revised federal Stamp Tax Act, aimed at improving the competitiveness of the Swiss financial center, entered into force. Concerning the issuance of securities, the following activities were exempted from the stamp tax: issuances in domestic investment funds, issuances in connection with corporate reorganizations, and the transfer of a company's domicile from abroad into Switzerland. For transfers of securities, trade in Swiss and foreign money market instruments, and transactions in foreign bonds through a Swiss intermediary are now exempt from the tax. Other transfers, such as transactions with foreign banks or foreign brokers in securities issued by a foreign issuer, and transactions by professional security dealers for their own trading portfolios, are subject to 50 percent of the stamp tax.

A new banking law as well as a reformed law on investment funds will soon enter into force. A federal law on stock exchanges is currently being finalized by the Parliament.

Banking Law

The federal administration is working on an ordinance to implement a new banking law that was approved by Parliament in the spring of 1994. The new law permits foreign banks to open up subsidiaries, branches, or representative offices in Switzerland without approval by the Federal Banking Commission (FBC). This opportunity for foreign banks is based upon reciprocity, and

the government of Switzerland, vis-a-vis countries where it does not have extensive contacts already, will require a written assurance that reciprocal access is provided.

The new law also requires banks to announce any acquisition or sale of its shares by a major shareholder (minimum 10 percent of capital or voting rights) to the FBC (shareholders engaging in such activity must notify the bank). Major shareholders have to guarantee that they will not exert their influence in a way that would undermine fit and proper conduct by the bank. To enforce compliance with these shareholder requirements, the FBC is authorized to block their voting rights. Finally, the FBC will be authorized to exchange information and documents with foreign bank supervisors. The latter will be able to pass information transmitted by the FBC to their criminal authorities only if the FBC approves it. This modification will not change legal assistance, but speed up exchange of information between authorities investigating criminal matters. The law should enter into force in January 1995.

Stock Exchange Law

The federal administration is working on an ordinance to implement a new stock exchange law that has to be approved by parliament (probably before the end of 1994). It would replace the existing system of cantonal regulation of stock exchanges by a federal law, and the Federal Banking Commission (FBC) would get the additional responsibility to supervise the securities market. The new law would give FBC more flexibility in adopting its guidelines. Moreover, the proposed law is characterized by a high degree of self-regulation, and contains the principle of national treatment. It should enter into force in mid-1995.

Investment Funds

Besides the new banking law, the Swiss government has completed an ordinance for a new law on investment funds that was approved by parliament in March 1994. Aimed at updating Swiss legislation to meet current market conditions, the new law has been drafted in terms compatible with EU legislation. To encourage financial institutions to keep their funds in Switzerland, the new law removes all restrictions on the type of assets they can hold. Together with the partial removal of the stamp tax in April 1993, this liberalization should favor the establishment of investment funds in Switzerland. The new law is scheduled to enter into force in January 1995.

OTHER EU AND EFTA — UNITED KINGDOM

Her Majesty's Government (HMG) has implemented all of the EU directives that have been passed and that are required to be implemented as of mid-1994. These directives include, inter alia, (1) the Second Banking and Coordination Directive (SBD), (2) the Own Funds Directive, (3) Solvency Ratio Directive, (4) Large Exposure Directive, and (5) Consolidated Supervision Directive. Other Financial Services Directives cited in the chapter on the European Union are either in draft stage in Brussels or in the course of implementation in London. The Investment Services and Capital Adequacy directives fit the latter category. Also, the Insider Dealing Directive and the Money Laundering Directive have been approved and implemented in the U.K.

The process of implementing the EU Financial Services Directives in U.K. law has been open and iterative. HM Treasury, the Bank of England, the Securities and Investments Board and relevant self-regulatory authorities worked together on the regulations and rules needed to give effect to the directives. The regulatory authorities and HMT circulated consultation documents on the proposed rules and regulations changes to the financial communities, both domestic and foreign-based, and other interested parties to seek their comments. This process sometimes involved several iterations of draft and review. The end product, consequently, reflected a genuine give and take between the public and private sectors and between prudential concerns and a workable, efficient market with fair rules and a level playing field. American firms participated actively through a variety of vehicles to ensure that their interests were protected. (HMG used essentially this same interactive process with the private sector as it simultaneously worked with the Commission and other member states in Brussels to develop the original EU directives.)

The directives approved so far were implemented either through secondary legislation prudential note or regulatory rules. Statutory Instrument 1992 No. 3218, The Banking Coordination (Second Council Directive) Regulations 1992, gave local legal effect to the SBD and came into force on January 1, 1993. The Solvency Ratio Directive and the Directive on Own Funds were implemented by prudential notes from the Bank of England in December 1990 and were effective no later than January 1, 1993. The relevant citations are BSD/1990/3 for the Solvency Ratio Directive and BSD/1990/2 for the Own Funds Directive. Meanwhile, the Consolidated Supervision Directive was implemented by BSD/1993/1 in February 1993 and was effective immediately. The Large Exposures Directive was implemented by BSD/1993/2 in October 1993 and was effective January 1, 1994.

The U.K., which is perhaps the most open of the major financial markets, retained that distinction in the implementation of the five directives. There is no indication from players in the marketplace of any discrimination against foreign firms. Full national treatment is provided to all players.

Moreover, HMG authorities have not, to our knowledge, employed host country residual authority under the provision of "the conduct of business" or for "the interest of common good" to harbor discriminatory treatment against foreign firms. Discriminatory treatment would undermine what is generally perceived both in government and in private sector circles as the government's overriding objective to maintain London's status as the premier financial center in Europe.

Given the array of directives developed by the EU to establish the single market, one has to wonder why there has not been a rush of actions, such as cross-border branch networks or mergers, to take advantage of the new regime. According to many sources in London, the single market directives have in some respects actually made cross-border activity more bureaucratic and cumbersome. More importantly, however, the directives have not addressed the more difficult barriers in the market — culture taxes and pension portability.

CZECH REPUBLIC

BANKING

SUMMARY

The banking sector has been a central element of the highly successful Czechoslovak (and later, Czech) economic transformation that began in 1990 just after the "Velvet Revolution." Banking sector reform has remained on track since 1990, despite the break-up of the Czechoslovak federation at the end of 1992. The banking sector continues to evolve quickly but still faces a number of serious challenges. These include high lending margins and very conservative lending practices; a significant level of bad debts; a shortage of trained bank personnel; and inadequate supervision of bank irregularities, especially in the new domestic banks. The government and the Central Bank are moving quickly to address these problems, through administrative improvements and through two banking law amendments, one of which became effective in July 1994 and the other expected to be passed in the near future.

The "Big Four" banks in the Czech Republic — Komercni Banka (Commerce Bank), Cseka Spuritelna (Czech Savings Bank), Ceskoslovenska Obchodni Banka (CSOB=Foreign Trade Bank) and Investicni/Postovni Banka (The Investment/Postal Bank) — control 70 to 75 percent of the domestic market for most banking services and hold 78 percent of the banking assets. Many of these assets were inherited from the Communist period. The government holds a significant interest in each of the "Big Four," which it has indicated it plans to reduce over time. A second tier of five or six medium-sized banks have 7 to 8 percent of the market. The remaining banks are very small, new, private banks (domestic and foreign) with specialized niches.

The Czech National Bank is an independent monetary and regulatory authority with responsibility for licensing and regulating banking activity. The Central Bank has had a liberal policy of issuing bank licenses, with nearly all banks receiving universal licenses. This policy has stimulated rapid growth of the banking sector. As of mid-1994, 56 banking licenses had been issued, with 51 operating banks and 53,000 employees. In May 1994, the CNB decided to impose an informal, temporary "time-out" on issuing new banking licenses, which applies equally to both foreign and domestic applicants.

Foreign bank participation has been welcomed as an important part of the strategy to upgrade the banking sector and to help make domestic banking more competitive. With a few minor, temporary exceptions, foreign banks can compete on the same terms as domestic banks and are free to establish joint ventures, subsidiaries, branches, offshore branches, or representative offices.

There are currently 12 commercial banks with foreign participation, 10 foreign-owned subsidiaries, 9 foreign-owned branches and a number of representative offices. U.S. banking

presence in the Czech Republic is currently very limited. Chase Manhattan, Bankers Trust, JP Morgan and Chemical Bank have established representative offices. Citibank is the only fully operational U.S. bank in the Czech Republic. It is one of the more significant foreign bank operations, organized as a subsidiary that engages in a limited range of activities.

DESCRIPTION OF THE MARKET

Structure of the Banking System

During the communist era, there were only four state-owned Czech banks with a combined total of about 19,000 employees. These included the Czechoslovak State Bank, a "monobank" that combined central bank functions with a monopoly on domestic financing activities (with the exception of investments); the Czechoslovak Trade Bank (CSOB), which had a monopoly on foreign trade financing; the Czechoslovak Savings Bank, which had a savings bank monopoly; and Zivnostenska Banka, a small merchant bank.

The banking sector has been evolving rapidly since banking reform began in January 1990. Over 40 new banks have been established and employment in the sector has increased from 19,000 to 53,000 as of mid-1994. The banking sector now includes 43 banks with universal licenses, 9 foreign bank branches, 10 foreign subsidiaries, and 4 building and loan associations.

However, the sector is still dominated by the "Big Four" banks, consisting of Komercni Banka (The Commerce Bank), Ceska Sporitelna (The Czech Savings Bank), Obchodni Banka (CSOB - The Trade Bank), and Investicni/Postovni Banka (The Investment/Postal Bank). Combined, they have an estimated 70 to 75 percent share of most banking activities and 78 percent of the banking sector's assets. All four banks have universal licenses and are expanding their activities. They, along with one medium-sized merchant bank (Zivnostenska Banka), were the only banks in the Czech Republic to inherit assets and liabilities from the communist banking system. As of June 1994, the Czech Republic owned 90 percent of CSOB, 48.6 percent of Komercni Banka, 43 percent of Ceska Sporitelna, and 34 percent of Investicni/Postivni Banka.

Prior to 1989, virtually all Czechoslovak foreign trade and major projects abroad were financed through CSOB, with loan decisions made by the central planning authorities. CSOB still holds an estimated 70 percent share of the foreign financing market. As of April 1994, CSOB managed a foreign investment portfolio of over k300 million, estimated to be about 60 percent of total foreign portfolio investment in the country. CSOB is currently cleaning up its balance sheet to remove bad debts generated under the communist trading system. Complete privatization of the bank is under consideration.

Ceska Sporitelna (formed in 1990 to cover the Czech Republic) is the successor organization of the Czechoslovak State Savings Bank, which had a monopoly as the country's only savings bank

during the communist era. Ceska Sporitelna still has an estimated 50 percent market share of client deposits, including 87 percent of household savings accounts. It has traditionally been the primary source of funds on the domestic interbank market. The bank has grown to approximately 17,000 employees and 2,200 branches, 800 of which are full service offices. About 20 percent of its business is now corporate finance and credits. The bank has 200,000 foreign currency accounts. One of its subsidiaries has the Czech Republic's largest investment privatization fund. (Similar to mutual funds, these were formed in 1991 to manage the publicly held stock of large state enterprises that have been privatized.)

Komercni Banka and Investicni Banka were formed in January 1990, when the commercial banking functions of the Czechoslovak National Bank (The State "Monobank") were separated from the central banking functions. Long-term investment assets were transferred to Investicni Banka and the assets of the remaining commercial activities were transferred to Komercni Banka. Both banks were established to cover activities in the Czech Republic.

The liability side of both banks' balance sheets consisted primarily of short- to medium-term funds from Ceska Sporitelna. Komercni Banka is the largest commercial bank in the Czech Republic, holding 28 percent of the banking sector's loan market and 300,000 foreign currency accounts. The bank's staff has grown from 4,000 in 1990 to 16,500 in early 1994, with 450 branches. In 1993, Investicni Banka merged with Postovni Banka (a bank specializing in bill payment and funds transfers through Czech post offices) in order to build up its retail business. The merged organization is now known as Investicni/Postovni Banka.

In addition to the "Big Four," there are five or six medium-sized domestic banks that have a combined share of 7 to 8 percent of most financial markets. These are all Czech-owned banks, although some have formed joint ventures with foreign partners. All have universal banking licenses and, with the exception of Zivnostenska Banka, which was formed in the 19th century, all were established after banking reform started in 1990.

The 40 or so small banks are either newly formed domestic banks or highly specialized foreign banks (both subsidiaries and branches). Most observers believe there are too many banks in operation for the size of the market and that over the next several years some of the newly established Czech banks will either go out of business or be absorbed by the larger banks. The foreign banks, on the other hand, are considered to be positioning themselves to rapidly expand their activities once the Czech crown reaches full convertibility (probably in 1996 or 1997).

The government has supported the formation of two specialized banks since 1990; the Consolidation Bank (Konsolidacni Banka, or KOB) and the Czech-Moravian Guarantee and Development Bank. The government has also backed the formation of the Export Guarantee Insurance Corporation (EGAP), technically an insurance company, which promotes exports by guaranteeing trade credits. EGAP is in the process of establishing an export banking subsidiary, the Export Bank, which should begin operation in the fall of 1994.

The Consolidation Bank was established under the Ministry of Finance in 1991 as a financial institution to help recapitalize Komercni Banka and Investicni Banka by purchasing $2.7 billion of their residual "bad loans" incurred during the communist era. The "bad loans," generally low interest (1 or 2 percent) perpetually revolving credits, were renegotiated with the debtors to 8 year, 13 percent loans. The Consolidation Bank issued bonds to Komercni Banka and Investicni Banka to buy the bad assets. The Consolidation Bank paid off the bonds by the end of 1992, ahead of schedule, using funds from privatization sales channeled through the National Property Fund. Debtors with the renegotiated loans have generally repaid the Consolidation Bank on schedule.

In 1993, the Consolidation Bank's operations were expanded to include the acquisition of defaulted debts from former state enterprises that had declared bankruptcy. The government has authorized the Consolidation Bank to purchase such debts at 60 percent of face value. The purpose of this scheme is to minimize the danger of a wave of bankruptcies by injecting capital into the system. Large numbers of bankruptcies have not materialized and, as of March 1994, the Consolidation Bank has only authorized the expenditure of k3 million to purchase defaulted debt at a discount.

The Consolidation Bank has also been involved in some other significant government directed financial operations, including buying additional bad debt at 80 percent of face value from Investicni Banka in 1992, and repurchasing Czechoslovak Airlines (CSA) stock from Air France in early 1994. The Consolidation Bank also began limited commercial operations in 1992 related to project financing and support of export companies. There is currently a proposal pending to allow the Consolidation Bank to strengthen the balance sheets of weak domestic banks through a variety of capital infusion schemes.

The EGAP and the Czech-Moravian Guarantee and Development Bank are small institutions established in 1992 and 1993, respectively, to promote exports and promote the development of small and medium-sized businesses. Both received initial capitalization from the government, but have subsequently become joint-stock companies. EGAP provides export financing insurance. The Czech-Moravian Guarantee and Development Bank was established with an initial capital base of about k50 million to support small and medium Czech businesses through various forms of loan subsidies and guarantees. Credits are allocated in accordance with regional development objectives.

Regulatory Structure

The Czech National Bank CNB) is an independent monetary and regulatory authority that has responsibility for licensing and regulating banking activity. Bank regulation is still undergoing changes based on two significant amendments to the banking law (one already in force and the other due in the near future). A "small amendment," in force since July 1, 1994, is being used by the government to deal with immediate problems resulting from three cases of bank irregularities that occurred in early 1994. The amendment provisions include: a) tightening the regulatory and supervisory authority of the CNB over the banking sector; b) establishing mandatory deposit insurance that covers 80 percent of the deposits of small personal accounts (up to k100,000); and a "large amendment" is expected to be approved in late 1994 that will establish a broader range of legal norms for banking activity including, for example, standards for payments settlement systems, the protection of clients against bank mismanagement, accountability systems, money laundering provisions, and a legal basis for mortgage banking (which currently does not exist in the Czech Republic.)

The Central Bank has a liberal policy of issuing bank licenses, with nearly all banks receiving universal licenses. This policy has stimulated rapid growth of the banking sector. As of mid-1994, 56 banking licenses had been issued, with 51 operating banks and 53,000 employees. The minimum capital requirement for locally incorporated commercial banks is k500 million (US$17 million). Not all banks with universal licenses can engage in foreign exchange activities. The license permitting foreign exchange activities is normally issued at a later date based upon the bank's proven ability to manage this function. In May 1994, the CNB decided to impose an informal, temporary "time-out" on issuing new banking licenses, which applies equally to both foreign and domestic applicants.

By mid-1992, the CNB determined that the country's macroeconomic stabilization policies had been sufficiently successful to warrant discontinuance of direct monetary management measures, such as controls on lending and interest rates. A system of flexible management was adopted using indirect monetary instruments, including statutory reserve requirements and the discount rate. Additionally, the refinancing system was developed and diversified to include a credit auction system at interest rates determined by market demand. CNB treasury bills were introduced in 1992 as supplementary instruments to influence monetary policy and banking system liquidity. More recently, the CNB has begun to use additional instruments, including swaps, repurchase transactions, and purchase/sale of secondary market securities.

The CNB's policies have generally been anti-inflationary, in accordance with the government's strong commitment to conservative economic policies. Since June 1991, the underlying inflation rate has been about 10 percent, although there was 20 percent inflation in 1993 due to the introduction of a new value-added tax. Over the past year, the statutory reserve ratio has been in the 3 to 4 percent range for long-term deposits and the 9 to 12 percent range for short-term and sight deposits. The discount rate has been in the 8 to 9.5 percent range. As of June 1994,

commercial banks were paying from 2 percent to 2.5 percent interest on current accounts, 6 to 7 percent on deposits up to 3 months, and 12.5 to 13.5 percent on 3- to 4-year certificates of deposit.

Banking System Issues

Although there has been substantial progress in transforming the banking sector, the process is not complete and a number of significant weaknesses remain. These include 1) high lending margins and very conservative lending practices, resulting in a lack of effective competition; 2) a shortage of trained and experienced bank personnel; 3) residual bad debt, questionable lending practices and weak balance sheets; and 4) inadequate banking supervision and the related potential for banking irregularities. The government and CNB also see a need for additional banking legislation, particularly covering mortgages.
CNB and the Czech government are aware of these weaknesses and are working to correct them. Although the government may be able to solve some of these problems through legislative or administrative remedies over the next year or so, structural problems will take longer.

Lack of Effective Competition

The government believes that there is a lack of competition in the banking sector. It argues that domination of the market by the "Big Four" banks has encouraged high interest margins and extremely conservative lending practices. Most commercial banks had a spread of 6 to 7 percent in 1992, which decreased only marginally in 1993 from competitive pressure from the small banks and offshore borrowing. Senior CNB and government officials have heavily criticized the banks for being noncompetitive, arguing that the current level of macroeconomic stability does not justify the high interest spreads. The "Big Four" respond that high interest margins are necessary to finance bank expansion and to build up provisions for residual bad loans.

The CNB and the government have been attempting to put pressure on spreads to decline by welcoming foreign bank operations. Thus far, foreign banks (with the exception of some German and Austrian banks) have not shown much interest in engaging in retail banking activities in the Czech Republic. However, there has been a substantial increase in direct foreign lending (US$984 million) in the first half of 1994.

There are two significant factors that have contributed to the banks' tendency to pursue conservative lending practices. One is that the Czech microeconomic transformation is at an early stage; there is still a short supply of sound business proposals presented to the banks for financing. Second, the banks are still uncertain about the priority status of loans, should defaults occur. At present, there is no central filing system for liens that would allow banks to quickly seize collateral, and there is a three to four year backlog of bankruptcy cases in the court system.

Shortage of Trained Personnel

The number of banking sector employees increased from 19,000 in 1990 to 53,000 at the present. Czech bankers generally cite the shortage of qualified bank personnel as the primary challenge confronting the banking sector. An estimated 75 to 85 percent of current bank personnel have less than three years banking experience; the few with more than five years experience were trained in the communist banking system. The major banks are therefore beginning to place a high priority on bank training, by building up their own training departments and working with the Banker's Training Institute, now an independent joint-stock company originally established by the Central Bank. Foreign assistance providers, including USAID, place a high priority on banking sector reform and have devoted considerable resources to supporting banking training.

Bad Loans

An estimated 20 percent of bank loans are considered to be doubtful or in default. In addition to residual bad loans left over from the communists and still in the Big Four banks, a significant number of post-1990 loans are in default as a result of bad credit decisions. However, the current level of bad loans is a marked improvement over the estimated level of 57 percent of total banking sector assets in 1990. The level of bad credits has been reduced through a series of government-directed actions that include purchases by the Consolidation Bank, two rounds of calculations to cancel out mutual inter-enterprise debt, and the transfer of CSOB's k2.5 billion of nonperforming foreign debts to the CNB's special accounts. Although the banks have written off about k6 billion in bad loans since 1990, the total equity of Czech banks has remained constant due to compensating capital inflows. The level of credits extended in the Czech Republic has also remained relatively constant at about k700 billion (US$24 billion).

The continued existence of "old boy networks" linking the large Czech banks to financially weak state (or former state) enterprises has led to the continuation of soft or involuntary credits (i.e., debtors who refuse to pay). CNB and government officials are concerned that such networks continue to result in loans and loan extensions that are not warranted on the basis of sound credit analysis criteria, slowing the microeconomic transformation process.

Banks also have been reluctant to pursue bankruptcy claims because they do not consider it to be a worthwhile strategy. They believe that potential asset recovery is generally greater by rolling over defaulted debts than by seizing collateral for which there is no secondary market. Additionally, as already noted, there are delays of three to four years in pursuing bankruptcies through the court system.

Inadequate Banking Supervision

An additional problem is the high potential for banking irregularities. The recently established Czech banks appear to be most vulnerable. Government officials are concerned that some of these banks were formed without adequate capital or experienced bankers. During the first half of 1994, the first three serious cases of bank irregularities occurred, resulting in the CNB imposing forced administration.

In the case of Bank Bohemia, its top management had engaged in fraudulent financial activities; several bank directors attempted to sell k1.2 billion worth of fraudulent "prime bank guarantees" on the international market between May and December 1993. CNB bank supervisory authorities became aware of the situation in early December 1993, but did not take decisive action until the following February, after being approached by the U.S. Securities and Exchange Commission. In the other two cases, AB Bank and Credit and Industrial Bank stretched their credit activities beyond their capabilities.

These three cases of bank misconduct led to an overhaul of bank supervision and licensing. As a result of the Bank of Bohemia case, the CNB has increased the number of its bank supervisory personnel from 30 to 50. Additional bank supervisors may be hired later in 1994. A number of governmental and international organizations have worked closely with the CNB to help it upgrade the bank supervision structure and procedures and help train personnel.

In addition to improving bank supervision, the CNB is gradually implementing stricter prudential criteria for banks. In the past, the CNB enabled Czech commercial banks troubled with inherited bad loans to draw credits from its emergency fund. This possibility was significantly narrowed in the middle of 1994.

Additional Banking Legislation

The government intends to pursue additional banking legislation to establish mortgage banking and to meet norms for entry into the European Union (EU). Although mortgage banking is permitted under universal banking licenses, mortgage lending has not yet started. The government has not yet attempted to privatize the housing market. Rents remain extremely low, and there is very little private sector demand for new housing at much higher free market prices. From the banking perspective, it is unclear whether residential real estate can effectively be used as collateral, due to legal limitations on eviction of defaulting borrowers. In the coming year, the government may address these issues, in addition to establishing guidelines for the organizational structure of mortgage banking.

During the next two to three years, the Czech government will, upon the initiative of the CNB, move ahead with legislation that will bring the Czech banking system up to EU norms. EU

membership is the Czech government's highest economic priority; the government is likely to apply for membership by the end of the decade.

U.S. PRESENCE IN THE MARKET

There are currently 12 commercial banks with foreign participation, 10 foreign-owned subsidiaries, 9 foreign-owned branches, and a number of representative offices. Although Czech entities obtain offshore credits from the United States, U.S. banking presence in the Czech Republic is currently very limited. Chase Manhattan, Bankers Trust, JP Morgan, and Chemical Bank have established representative offices. Citibank, one of the prominent foreign banks in the Czech Republic, is organized as a subsidiary. It has a universal banking license and can trade foreign exchange.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign bank participation has been welcomed as an important part of the strategy to upgrade the banking sector and to help make domestic banking become more competitive. Foreign banks can compete on the same terms as domestic banks and are free to establish joint ventures, subsidiaries, branches, offshore branches, or representative offices. However, the CNB recently adopted a temporary, informal "time-out" on issuing new banking licenses. The CNB has indicated that this applies equally to both foreign and domestic applicants. CNB officials have stressed the temporary nature of this moratorium. Foreign banks are eligible for universal banking licenses and licenses to trade foreign exchange.

As of June 1994, there were only two minor restrictions regarding the treatment of foreign banks. Both exceptions are temporary. The government currently guarantees only deposits of individuals with the Czech Savings Bank. This exception will end when the deposit insurance system is implemented in 1994. The system will cover personal deposits of all banks except those of incorporated entities. The current government guarantee also does not extend to the deposits of legal entities. Secondly, the CNB currently observes an informal guideline setting a 25 percent foreign ownership limit on any of the Big Four banks. For the near future, the government will maintain a significant but decreasing level of ownership in the Big Four banks.

Two discriminatory practices implemented in 1990 that favored domestic banks no longer exist. For the first several years of bank reform, foreign banks were allowed to establish subsidiaries but not branches. This effectively limited foreign banks' domestic lending capability to the level of their in-country capital base. (In 1990 Citibank was required to establish its operation as a subsidiary, rather than as a branch, under the policy then in effect.) That policy has subsequently been abandoned. Now that branches are permitted (which allows the banks to use offshore capital in computing their capital adequacy ratio) this is no longer a problem.

Secondly, the Big Four banks and Zivnostenska Banka were given until the end of 1993 to meet the 6.25 percent capital adequacy ratio (the banks' own assets related to risk weighted assets), which applied immediately to all other banks. All five banks met the 6.25 target by the end of 1993; the ratio has now been set at 8 percent for all banks by 1996.

There have been no complaints from the U.S. banking community regarding discriminatory treatment in the banking sector.

CZECH REPUBLIC

SECURITIES

SUMMARY

The creation of an active, viable capital market was an integral part of the Czechoslovak government's post-revolutionary economic reforms. The last active market closed some 50 years ago, and the Czechs had no working knowledge of capital markets or market operations. However, within 18 months after the downfall of the communist regime the post-revolutionary federal government had created laws establishing a banking system and a capital market. By the spring of 1993, a new stock exchange had begun operations in the successor Czech Republic, following the dissolution of the federation.

The Czech Republic's capital market is currently composed of an equities market, a Treasury bill and government bond market, a corporate short- and medium-term debt instrument market, and an interbank deposit market. Banks, securities firms, and insurance companies all may participate. Mutual funds, pension funds, and developing thrift institutions are expected to become more active in the future. There are no options or derivatives markets in the Republic, although options on Czech equities trade in Vienna and Bratislava.

Foreign investment in the equities market is approximately 3 percent of total capitalization. Although comprising a relatively small percentage, foreign investment was largely responsible for propelling stock prices to new highs in early 1994. Some observers believe that as much as 40 percent of outstanding bond issues are in foreign hands, although no firm figures are available. There is a limited secondary bond market in the Czech Republic, although some Czech hard-currency municipal bonds trade on the London and Tokyo Exchanges.

In the first internationally recognized investment grade ratings awarded to any post-communist country, Moody's Rating Services gave the Czech Republic a Baa rating in the spring of 1993 and awarded the city of Prague a similar rank later that same year. Current ratings of the CR are Baa 2 (Moody's) and BBB+ (Standard and Poor's).

U.S. presence in the market includes the representative office of one securities firm and the locally incorporated affiliate of another firm. U.S. banks are active in the bond market and have one seat on the Prague Stock Exchange. The Czech government actively encourages foreign participation in its capital markets and U.S. firms have not reported any instances of discriminatory treatment.

DESCRIPTION OF THE MARKET

Stock Exchange

Czechoslovakia's capital market shut down during Nazi occupation in 1939 and remained closed under Communist rule. The 1989 Velvet Revolution ushered in a government of economists, dedicated to creating a Western-style market economy in Czechoslovakia. The new government recognized the importance of a viable capital market for the transition.

In 1991, the Czechoslovak State Bank officially proposed the creation of a securities exchange, and in early 1992 the Stock Exchange Law was passed. The country's eight leading banks, along with four other Czech and Slovak financial institutions and five brokerage companies, joined to form a Stock Exchange Planning Committee. After the Stock Exchange Law was passed, this committee became the Board of Directors of the Prague Stock Exchange.

Representatives of the French Stock Exchange advised the Czechoslovak planners and provided computer software. The software was supplied to the Czechoslovaks at no cost and is still in use. Similar to the software employed on the Warsaw Stock Exchange, it is adequate for the small Czech securities market, but difficult to expand and incompatible with many other European systems.

Under the current automated trading system, members submit bids electronically until 10:00 a.m. The computer then fixes a price based on these bids and offers. When a price is fixed for an issue, all trades in that issue on that day will take place at the fixing price. The exchange is forbidden to clear its own trades and has set up a subsidiary firm for that purpose. It runs its own register of ownership information, the Central Register of Securities (CRS). Before trades are consummated, CRS verifies that the seller actually holds the securities it is offering. Trades are usually settled within three business days after the order is placed, although additional delays due to missed communication and other inefficiencies are not uncommon. It is not possible to cancel trades, but in the event of a default, a fund established by the exchange members guarantees performance.

OTC Market

In addition to the Prague Stock Exchange, another securities market called "RM-System" (RM-S) opened for trading on June 18, 1993. An over-the-counter equity market, RM-S grew out of the government's large-scale privatization program and was established to serve the needs of the individual investor. RM-S is significantly slower than the Prague Exchange and currently holds approximately one trading day three times a week.

Whereas the Prague Stock Exchange had originally been designed for institutional investors trading "blue chip" stocks, RM-S was intended to handle the second- and third-tier stocks not

listed on the Prague exchange. Beginning in May 1993, however, the Prague Stock Exchange Board of Directors opted to permit trading in a wider selection of firms, gradually including nearly all privatized companies. This had led to virtually complete overlap in coverage between the two markets. Institutional investors generally prefer to do their trading through the more efficient and prestigious Prague Stock Exchange; small investors still trade mostly through the cheaper and more convenient RM-S. RM-S has offices throughout the country staffed by personnel specifically trained in handling orders, an important factor for the average Czech citizen, who may still be somewhat daunted by the concept of stock trading.

As of early 1994, approximately 2 percent of Czech shares were traded on RM-System and 8 percent on the Prague Stock Exchange. Roughly 90 percent of shares were traded directly, outside of the automated trading systems. Some Czech stocks are now being traded on the more efficient Vienna bourse as well, and the central bank of the Czech Republic, the Czech National Bank (CNB), estimates that the volume of Czech shares sold there will soon approach two to three times that of the Prague Stock Exchange. Virtually all of the nearly 1,000 now-privatized companies are tradeable either in Prague or in Vienna, and 900 government-owned firms to be sold in a second wave of privatization will also be traded on these markets. As of April 1994, total market capitalization was approximately $15 billion, and the book value of the firms tradeable on the Prague exchange was approximately $12 billion.

Characteristics of the Market

Traders and others involved in the Czech equities markets, although generally pleased with the market's performance to date, point to a number of shortcomings.

The inadequacy of the broker network and absence of market makers, for instance, have created a severe liquidity problem in the market, particularly for institutional investors buying or selling large lots. This illiquidity may contribute to the amount of trading, 90 percent, that occurs off-market. Additionally, there is a paucity of data on publicly-traded firms. Although disclosure regulations are on the books, enforcement is weak and the regulations themselves are often open to interpretation. In addition, many observers are concerned about the relative lack of market regulation. There is no independent, SEC-like body in the Czech Republic and little interest in forming one. While to date only a few cases of abuse have been uncovered, most feel that theft of shares, insider trading, and other market irregularities will increase until the government exerts more supervision over market activities. At this time, a department of the Ministry of Finance is the only supervisory body.

Czech investment funds own approximately 70 percent of all Czech shares, although this percentage will decline in the second wave of privatization, when only 45 to 50 percent of the new vouchers will be allocated to investment firms. More than 200 funds are now licensed to trade in the Republic, although four of them (funds of the Czech Commercial Bank (Komerni Banka), the Czech Savings Bank (Ceska Sporitelna), the Czech Investment Bank (Investicni

Banka), and Harvard Capital Consulting control approximately 80 percent of shares held by institutions.

Czech equities trading has been surprisingly successful to date. Although shares dipped heavily when trading began in the summer of 1993, they rebounded in early Autumn when foreign investors become active in the Czech market. By November of that year, foreign interests were investing as much as $100 million per month in the market. From December 1993 through February 1994, the market rose continuously, and the average share price approached 30 times earnings. An index of the largest Czech equities rose approximately 400 percent from late August 1993 through February, and roughly 50 percent from January through February 1994 alone. The market peaked in late February, as rising U.S. interest rates made American and Western European investors jittery. As a result, in the Czech and other emerging markets, foreign investors engaged in widespread profit-taking, reinvesting in safer markets. As of mid-April, prices on the Prague Stock Exchange subsequently fell 50 percent in the next few months, but then started to edge up again. As of late April 1994, most observers believed that the downturn in the Czech equity market was simply a correction, and not a long-term trend.

Analysts see medium- to long-term prospects as good, however, based on the country's strong economy and globally sound macro-economic fundamentals. They note that the government here is highly sensitive to the needs of foreign investors and is committed to keeping the Czech Republic on firm economic footing. There are no significant political problems in sight; inflation is low, the country is geographically well situated for access to the Western markets, and there have yet been no scandals or other significant problems on the markets. Investors are attracted to the wide variety of industrial firms available for investment, and current price/earning ratios are still significantly lower in the Czech Republic than they are in Poland or Hungary.

Debt Markets

The short-term government bond market was opened in the spring of 1992 to permit the Czechoslovak Ministry of Finance to finance deficit spending. For the first year, there was only one issue outstanding; but in mid-June 1993, the Czech Ministry of Finance initiated an active schedule of auctions to sell 4- and 12-week bills. Currently, the Ministry of Finance, the CNB, and the National Property Fund auction bills on a near-weekly basis. Auctions of government bonds occur at irregular intervals several times per year. Given the high yield of government debt issues and the investor-quality rating of Czech financial institutions, foreign interest in these issues is relatively high. As of September 1994, approximately 31 billion CZK of T-bills and 24.5 billion CZK (about $845 million) of government bonds were outstanding. Less than 7 percent of the value of government bonds was in foreign hands. The CNB portfolio included about 2 percent of government bonds in circulation.

The medium-term debt market was opened in 1992 with the issuance of the first straight, fixed-interest bond for the Czech firm Glavunion. Further medium-term bonds from the Ministry of Finance, from two of the largest banks, and from two major Czech firms, were issued in 1993. That same year also saw the issuance of various floating-rate bonds.

Foreign investment in Czech crown-based debt securities increased dramatically in 1993 and has continued to the present time. Foreign investors are attracted to the Czech debt instruments for several reasons. First, the exchange rate of the Czech crown in relation to the U.S. dollar and German mark is extremely stable. Second, many analysts consider the Czech currency to be undervalued against most major currencies and thus likely to appreciate in value over time. Third, interest rates offered in the Czech Republic compare favorably with virtually any developed country. And finally, investors are attracted to the political and economic stability of the country as a whole and generally see it as a safe place for medium- to long-term investment.

Because the Czech government maintains a budget surplus, it is not generally a significant borrower. The resulting limitations on the amount of government debt has somewhat retarded the development of the Czech debt market. As of May 1994, an American investment firm active in the Czech debt market estimated that the total value of outstanding crown-denominated debt securities is only approximately $1.3 billion. This relative shortage of debt securities, in the view of a U.S. investment firm, indicates that considerable expansion of the Czech debt market is possible and likely practical. Currently, new issues are snapped up by investors and only rarely re-sold. This has placed obvious and severe limitations on the domestic secondary debt market. Observers see this lack of a secondary market as a serious shortcoming in the Czech capital markets.

Currently, 17 corporate bond issues trade on the Czech market. Additionally, a hard-currency bond for the city of Prague is selling on the London Exchange, and a hard-currency Czech government bond is traded in Japan and on Euromarkets.

The interbank deposit market in the Republic is active, particularly for one-day, seven-day, and one-month deposits. There is one broker in the interbank market and, at present, only two or three banks have a Reuters page where they can post their interbank rates. More are expected to acquire this ability in the near future.

U.S. PRESENCE IN THE MARKET

Currently, two U.S investment firms are located in the Czech Republic: Crédit Suisse First Boston (CSFB) operates a representative office, and Wood and Company is incorporated under Czech law. U.S. firms, principally CSFB, Wood and Company, Bankers' Trust, and Chemical Bank, have a role in bringing Czech bonds to market.

American involvement in the Czech capital markets is small but highly influential. Foreign investors purchase approximately $60 million in Czech equities each month, and the majority of this sum comes from U.S. institutions. Two U.S. investment firms (Crédit Suisse First Boston and Wood & Company) have offices in the Republic, although much of the direct trading by U.S. institutional and hedge funds takes place through Czech investment firms. Oppenheimer and Co., Inc., has formed a mutual fund - The Czech Republic Fund Inc., (CRF). It is registered on the New York Stock Exchange, which makes it possible to trade Czech securities on foreign markets or to arrange for U.S. dealers the access to the Czech market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The Czech government places no restriction on the establishment of foreign securities firms in the Republic. Foreign investors may purchase Czech stocks through a broker on the Prague Stock Exchange or through the RM-System. Some foreign institutional investors have direct access to the stock market; Citibank, for instance, was a founding member of the exchange and retains an inactive seat on the exchange.

To invest in foreign securities or issue a security abroad, Czech nationals must apply for a permit issued by the Czech National Bank. The Bank consults with the Ministries of Finance and of Industry and Trade. There are no other restrictions.

The Czech government has actively encouraged foreign participation in its capital markets, and U.S. and foreign financial institutions are accorded the same treatment as corresponding Czech firms. There are no discriminatory restrictions on foreign ownership of publicly traded shares or debt instruments, nor are there any limitations on non-Czech ownership of government securities.

Exchange Rates

Average 1993:	US$1 = 29.153 Koruny
End of year 1993:	US$1 = 29.955 Koruny
September 1994:	US$1 = 27.921 CZK

HUNGARY

BANKING

SUMMARY

Hungary's economy is in transition, from a centrally planned socialist economy to a free-market model. Although banking reform was initially a leading element of the transition, having begun in 1987 (three years before Hungary's first democratic change of government), it now lags behind the general reform process and may even be a drag to the country's economic growth.

As part of the reform process, Hungary implemented new accounting, bankruptcy and banking sector laws, designed to bring the country's business standards closer to those prevailing in the West. This required businesses (including banks) to more accurately reflect their financial situations. As a result of the new, more transparent system, and an overall decline in economic activity, banks (particularly large state-owned banks) were forced to acknowledge that many of their loans were of poor quality and to raise the level of problem loans in their portfolios by more than 1,000 percent. This intensified the problem that banks faced in raising capital/liability ratios to international standards, as called for in new banking sector law. That need, combined with the crowding-out effect of large state fiscal deficits, has led to reduced levels of lending to enterprises and dampened economic activity.

Government efforts to press forward with banking reform have not fully addressed the problems. Some observers have concluded that, by concentrating on the recapitalization of major state-owned banks, sufficient attention has not been devoted to improving internal/external controls or to encouraging corporate restructuring by borrowers. The state banks continue to dominate the banking system, with 70 percent of assets. Their market share, however, is declining fairly rapidly.

Many observers, including the newly elected Socialist-led government that took office on July 15, 1994, take the view that the solution to the problems faced by state-owned banks can only be resolved through their privatization. One of the four large state-owned commercial banks has found a strategic partner; a second is expected to do so by year-end.

The inflow of direct foreign investment, approximately $7 billion from 1990 through 1993, has created a new demand for highly developed financial services. To meet that demand, foreign banks (mostly Western European) have established wholly-owned subsidiaries or joint ventures with Hungarian entities. As of September 30,1994, there were 44 banks in Hungary, of which 22 had a foreign participation of over 50 percent.

Hungary has relatively liberal banking entry requirements; however, it does not permit foreign banks to establish in branch form. This restriction raises the cost of operating in the country. Only one U.S. bank, Citibank, is operating in Hungary. Citibank is a full service commercial bank and intends to establish a retail operation by year-end 1994. Bankers Trust operates, by choice, under a corporate license rather than a banking license.

DESCRIPTION OF THE MARKETS

Hungary's economy is in a state of transition, from a centrally planned socialist economy to a free-market model. Such a transformation requires fundamental change and has caused major dislocations. These dislocations are both reflected in, and have been exacerbated by, the parallel transitions underway in Hungary's financial markets.

The transformation of Hungary's financial sector began in 1987, three years prior to Hungary's first democratic election, with the establishment of a two-tiered banking system. The National Bank of Hungary (NBH) divested itself of its remaining commercial banking departments, and established three new commercial banks: the Hungarian Credit Bank, the Commerce and Credit Bank, and the Budapest Bank. Together with the Foreign Trade Bank, which had been separately established, and the National Savings Bank, these large state-owned institutions dominated the Hungarian financial system, accounting for 93 percent of all banking assets in 1989. However, by 1992, as a result of Hungary's liberal banking entry requirements and the market opportunities created by the shortcomings of the large government-owned banks, the market share of assets held by the largest state institutions fell from 93 percent to 70 percent. This trend has continued, as the number of small and mid-sized banks has doubled, to 31, since 1989. Approximately half of the 31 have some percentage of foreign ownership.

The transformation of Hungary's financial sector has in some ways, lagged that of the economy. The fact that banks, especially the large state-owned banks that still hold 70 percent of the assets of the banking system, are not efficiently functioning as financial intermediaries has hindered Hungary's economic growth. The banking system's failure to achieve effective financial intermediation is the result of the following:

- The tremendous dislocations resulting from the country's transition, including:
  - — a cumulative decline of over 20 percent in measured GDP since 1989;
  - — the collapse of exports to the former COMECON trading bloc, which as recently as 1989 accounted for over 90 percent of Hungary's trade;
  - — operating losses sustained by more than half of all Hungarian firms in 1992, for a total of more than 317 billion forints ($3.17 billion) or 11 percent of the GDP;
  - — an erosion of the banks' customer base, which greatly increased the risk involved in lending.
- The significant growth of the banking industry's problem loans: from 20 billion forints in 1989 ($200 million) to more than 300 billion forints ($3 billion) in 1993. An estimated 15 percent of all bank loans were problematic in 1993. Most of these problem

loans are in the portfolios of the large state-owned banks, with the remainder in the Hungarian mid-sized banks. Almost none are to be found in the foreign banks.

- New laws covering bankruptcy, accounting, and financial institutions, adopted in late 1991 and early 1992 in order to lay the legal foundation for market-economy operations, forced many firms to acknowledge that they were not solvent. With new valuations of loan portfolios, the largest state banks showed negative, and in some cases substantially negative, capital asset ratios (CAR). A new legal requirement that banks achieve a minimum 8 percent CAR by 1997 has placed increased pressures on banking institutions.

- A substantial increase in government borrowing. With a budget deficit that exceeded 7 percent of GDP in 1993 and with projections for the same in 1994, government borrowing has effectively crowded out some corporate sector borrowers. Loans to enterprises, which accounted for 74 percent of banks' overall loan portfolios in January 1992, accounted for only 52 percent by July 1993. Loans to the government rose from 7 percent to 29 percent of overall portfolios during that same period. Net bank credit to enterprises fell from 385 billion forints ($3.85 billion) in January 1992, to 342 billion forints ($3.4 billion) in August 1993, a real decline of 25 percent (adjusted for inflation and the impact of loan consolidation). Despite evidence of recovery in the fourth quarter, year-end data suggest that net credit to enterprises was stagnant for 1993, as a whole.

In an attempt to reverse the decline of the dominant state banks, and to reinvigorate their role in financial intermediation, the government introduced a loan consolidation/bank recapitalization scheme designed to gradually raise capital adequacy ratios to an 8 percent minimum required level, while laying new institutional safeguards to prevent a further deterioration in loan portfolios. Beginning in 1992, the bank reform program has, through several stages, led to the injection of over 300 billion forints ($3 billion) into the banks, raising the CARs of the major state banks to 4 percent as of May 31, 1994.

Despite the injection of capital into the major state-owned banks, the government has indicated its desire to privatize these institutions. One of the four large state-owned banks has found a partner. The government will sell 25 percent of the Hungarian Foreign Trade Bank to Bayerische Landesbank, and 17 percent to the European Bank for Reconstruction and Development (EBRD), late in 1994. Budapest Bank is also said to be searching actively for a foreign partner. The two remaining state commercial banks, the Hungarian Credit Bank and the Commerce and Credit Bank, need substantial restructuring before they will be able to attract an appropriate strategic partner.

Since 1989, Hungary has been the recipient of substantial inflows of foreign direct investment. More than $7 billion, half of all investment that has flowed into Central and Eastern Europe, has entered Hungary. Major firms from the U.S., Western Europe, and Japan have helped

develop such industries as automotive assembly, telecommunications, electronics, chemicals, and other manufacturing and service industries. This development has increased the need for commensurate financial services. Multinational subsidiaries, as well as blue-chip Hungarian companies (such as utilities), have become the focus of competition for all banks. Margins are small (negative in some cases where banks are seeking to maintain or increase market share), but rates are nevertheless high at 24 percent to 26 percent for best customers. Although these rates are the same or less than the central bank's 25 percent base rate, they are nevertheless, high compared to the 8 percent producer price index, which reflects manufacturers' price increases. As a result, many multinationals, and some Hungarian blue-chips, are choosing to raise funds offshore in foreign exchange. In the 12 months ending September 30, 1993, enterprises borrowed more than $800 million abroad. That level is expected to increase substantially in 1994. As the most credit-worthy borrowers utilize other opportunities to raise credit, the quality of banks' new loan portfolios is lowered but opportunities for smaller private enterprises to obtain funds are increased.

On the other side of the market, large Hungarian state-owned banks are faced with the prospect of dealing with many customers whose previous loans are now subject to the consolidation process. The newly elected government will have to decide what kind of role it will want the state-owned banks to play in the process of corporate reorganization. It is largely a problem for the state-owned banks, as foreign banks have very few of these firms, if any, among their customers.

There are a number of specialized credit programs for small and medium-sized businesses, funded by credits made available through foreign assistance programs and funnelled through the commercial banks, but they are inadequate to meet the needs of the sector. Beyond those programs, if loans are available at all, they are very expensive at 30 percent to 35 percent for the best of these borrowers. The consumer banking market is underdeveloped; checking accounts and credit cards are rare, and mortgage loans are scarce.

The National Deposit Insurance Fund, a compulsory system similar to that in developed financial markets, became operational July 1, 1993. There are two types of fees associated with the program: a one-time membership fee proportional to the institution's capital, and a regular annual payment based on total deposits, which is currently 1.8 percent. The fund does not yet provide universal coverage; as of September 30, 1993, it provided coverage of 39.5 percent of deposits, with state guarantees covering 33 percent. The remaining 27.5 percent of deposits are uninsured and/or uncovered. With the phase-out of government guarantees and broader inclusion for the fund, the fund eventually will cover 100 percent of deposits with a maximum coverage limit of 1 million forints ($10,000).

Efforts to reform the financial sector are underway, with the U.S. technical assistance program playing a significant role. It is the consensus view, however, that restoration of the health of the financial system will be accomplished only after the government divests itself of the state-

owned commercial banks. The incoming government has made divestiture an essential element of its economic program.

U.S. PRESENCE IN THE MARKET

At present there is only one U.S. bank, Citibank, operating under a banking license in Hungary. Citibank-Budapest was established in 1985 as the first of the joint venture bank, with 20 percent ownership held by the National Bank of Hungary (NBH). In 1993, Citibank bought the NBH's interest. Citibank-Budapest is now a 100 percent Citibank-owned subsidiary.

Citibank Budapest is engaged in the full range of commercial banking operations, including traditional lending, custodial accounts, foreign exchange, deposit taking from corporate clients, commercial paper underwriting, investment banking products, and electronic banking. By the end of 1994, Citibank will enter the consumer banking market as well. Through its retail outlets, Citibank will offer checking accounts, debit cards, and eventually credit cards and consumer lending. Citibank will also offer ATM services, which are not subject to any special regulatory mechanism.

Bankers Trust operates by choice under a corporate license. As a corporation (not a bank), Bankers Trust concentrates on international market placements, risk management, and advisory work. Bankers' Trust has chosen not to apply for a banking license because of its corporate strategy.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Once established, U.S. institutions are treated the same as domestic banks. However, foreign institutions are required to operate as subsidiaries and cannot enter as branches. Resident capital requirements are relatively high at one billion forints (about $10 million). As a consequence of the prohibition on direct branching, U.S. banks are not able to take advantage of their parent's capital for lending and face other additional costs associated with maintaining a locally incorporated entity.

Most problems associated with regulation are the result of an underdeveloped system rather than discrimination. For example, tax regulations have not been adequately vetted with the industry as a whole, which has caused a dispute between banks and regulators as to the valuation of gains in foreign exchange positions. That issue took two years to resolve.

HUNGARY

SECURITIES

SUMMARY

The securities market in Hungary was reestablished with the reopening of the Budapest Stock Exchange (BSE) on June 21, 1990, just two months after Hungary's first democratic election. In the four years since, the market value of listed securities on the exchange has grown from the equivalent of $100 million to over several billion dollars. Annual BSE trading, at the equivalent of $1.8 billion in 1993, may double in 1994. Another $2.3 billion in sales took place on the OTC market.

Government bonds and Treasury bills account for the large majority of the value of the BSE's listings, but corporate shares are rising in importance. There were six new listings in June 1994 alone, raising the total number of corporate listings to 36. However, the BSE has played a limited role in privatization.

Futures trading is conducted on the Budapest Commodities Exchange, which was established in 1989. Grain contracts comprise the majority of futures trading, although foreign currency futures are rising in importance.

Since the passage of the Commodity Exchange Act by Parliament in March 1994, futures trading has been more formally regulated. Only members of the Commodities Exchange may execute trades on the exchange. Local incorporation is necessary for membership. The application process is non-discriminatory, but there is no U.S. participation to date.

Foreign firms enjoy discrimination-free access to brokerage licenses. No U.S. firm has chosen to establish a trading subsidiary thus far.

DESCRIPTION OF THE MARKET

Hungary's two exchanges, the Budapest Stock Exchange and the Budapest Commodity Exchange, trade a range of financial instruments and futures contracts. The BSE lists stocks, bonds, investment trusts, and compensation coupons. The BCE lists futures contracts on grains, livestock, and foreign exchange; and plans to offer oil and interest rate futures contracts in the future.

The Budapest Stock Exchange

The Budapest Stock Exchange (BSE), which resumed trading on June 21, 1990, was the first stock exchange to reopen in the former communist states in Central and Eastern Europe following their return to democracy. Preparations for the BSE's reopening already were well

underway in the final months of the last communist-era government. The then-socialist Parliament passed the Act on Securities and the Stock Exchange in January 1990, three months before Hungary's first democratic election. The law came into effect February 1, 1990.

When the exchange resumed trading (BSE officials point out that the exchange was reopened rather than established), only one security was listed. By the end of 1990, six securities were listed. Today, 92 securities are listed (of which 36 are corporate shares, six newly listed in June 1994). In December 1990, the value of securities listed was just under $100 million. That value now exceeds $6 billion.

As shown in the following table, bonds (all but one government-issued) and Treasury bills account for the bulk of the value of the securities listed. As of May 31, 1994, (before the addition of six new corporate share listings), bonds and T-bills, at $4,392.9 million equivalent value, accounted for 73.4 percent of the value of listed securities. Compensation coupons — given to Hungarians for property lost under the communist or World War II fascist regimes — accounted for some 16.4 percent, $979.8 million equivalent, Shares, at $412.2 million equivalent, accounted for just 6.9 percent. There were 17 investment units (mutual funds), up from six at year-end 1993, at $202.2 million equivalent, accounting for 3.4 percent of the total value.

Budapest Stock Exchange, 1990-1994

	Jun 21 1990	Dec 31 1990	Dec 31 1991	Dec 31 1992	Dec 31 1993	May 31 1994
Number of BSE Members	42	42	48	48	47	58
Of which:						
Brokerage Firms	23	21	31	41	46	49
Banks	19	21	17	7	1	1*
Number of Securities on the BSE	1	6	22	40	62	86
Of which:						
Shares	1	6	20	23	28	30
Bonds			2	5	17	23
T-Bills				10	10	15
Investment Units				1	6	17
Compensation Notes				1	1	1
Securities Admitted to the BSE on Nominal Value (Millions of Dollars)	7.8	99.5	439.8	2264.2	4387.2	5987.1
Of which:						
Shares	7.8	99.5	240.6	343.1	380.3	412.2
Bonds			199.2	954.7	2356.5	2966.7
T-Bills				707.3	763.7	1426.2
Investment Units				20.7	89.3	202.2
Compensation Notes				238.4	797.4	979.8

*National Bank of Hungary.

Corporate shares also account for a significant and growing percentage of turnover volume, as shown in the table below. While accounting for only 9.8 percent of volume in 1993 ($181 million of $1,844 million total), the percentage of turnover volume accounted for by shares rose to 29.9 percent ($306 million of $1,048 million total) in the first five months of 1994. The number of trades is increasing dramatically, faster than the volume of trade, which may indicate that small investor interest is rising in the market. Turnover volume in 1994 may be double that of 1993.

Turnover on the Budapest Stock Exchange, 1990-1994
(millions of dollars)

	1990	1991	1992	1993	1994 Jan-May	Total
Turnover (Dollars) of Market Value	60.77	100.40	334.36	1,843.99	1,048.74	3,388.27
Of which:						
Shares	60.77	97.42	59.68	181.33	306.34	705.55
Bonds		2.98	122.74	728.70	220.77	1,075.19
Treasury Bills			149.55	844.09	433.04	1,426.68
Investment Units			0.30	0.99	0.49	1.78
Compensation Notes			2.09	88.88	88.11	179.08
Number of Transactions	4,962	14,509	8,565	23,749	28,645	80,430
Average Daily Number of Transactions	27	58	34	94	286	78
Average Daily Turnover	0.34	0.40	1.33	7.32	10.49	3.27
Turnover/Transaction	0.01	0.01	0.04	0.08	0.04	0.04

The BSE has shown quite a bit of volatility over its short trading history, but not nearly as great as its Warsaw counterpart. The BSE Index, fixed at 1000 on January 1, 1991, rose soon thereafter to about 1230, but began a measured decline thereafter, hitting its low of 667.03 on May 14, 1993. It then began a rapid rise, peaking at 2189.94 on February 2, 1994, a 238 percent gain in eight months, before falling off again. On July 11, 1994, it stood at 1448.12, one-third below its peak.

In October 1993, the BSE, together with the National Bank of Hungary and the Budapest Commodities Exchange, established a Central Clearing House and Depository. The clearing house provides for timely settlement of securities market and derivative transactions completed in Hungary, and stores and provides safekeeping of securities primarily for financial institutions.

There are 67 brokerages licensed to trade on the Budapest Stock Exchange, a relatively high number for the size of the market. Despite the high number of firms, there is a shortage of certified brokers. Although foreign firms enjoy discrimination-free access to brokerage licenses and over half of the existing brokerages have some share of foreign ownership, to date no U.S. firm has chosen to establish a subsidiary.

Trading hours are 11:00 a.m. to 12:30 p.m. weekdays (holidays excepted). Trading rights are limited to firms specifically established to engage in securities transactions. Banks and other financial institutions must set up dedicated, separate subsidiaries to participate in trading activity. Brokerage licenses are issued on a non-discriminatory basis, available to Hungarian citizens and to foreigners alike who fulfill the necessary criteria:

- the brokerage company must be a company registered in Hungary;

- the company must meet minimum capital requirements, depending on the license sought (see below); and

- managers and brokers must pass an examination on Hungarian securities law in the Hungarian language, given by the State Securities Supervision Office, and must present evidence of two years experience in securities transactions.

Minimum capital levels are low: a "full liabilities" brokerage, licensed to take part in initial offerings as well as operate in the secondary market, must have minimum paid-in capital of 50 million Hungarian forints (about $500,000 at the current exchange rate of approximately one United States dollar equals 100 forints). A limited liability company, which cannot underwrite issues, requires base capital of only 5 million forints ($50,000), or 10 million forints ($100,000) if established as a holding company.

As of late October 1994, a draft bill that would increase the reporting required by brokerage houses and raise their capital requirements was in committee in Parliament. It was expected to pass.

Privatization

The BSE has played a minor role in privatization. This is largely due to the government's determination to find strategic investors willing to pay cash for state assets. Additionally, the strict criteria for listing (three-year business history, financial reporting, capital levels) have been a barrier to companies. The former government made one attempt at mass-privatization on the BSE. The Small Investor Program (KRP) gave citizens deferred interest loans of approximately $1,000 to purchase shares of selected companies. The original plan called for shares of 80 companies to be made available on the BSE for KRP participants. The number shrank, ostensibly because few firms met the listing criteria but also because there was little political support for the program. After much delay and financial expense, the KRP was launched with shares from only two companies immediately before the May elections. After it took office, the Socialist-led government suspended the program immediately.

OTC Market

Of total market turnover of securities sales of $4.1 billion in 1993, $1.8 billion took place on the BSE and $2.3 billion took place on the over-the-counter market. According to officials of the State Securities Supervision Office (AEF), OTC volume has grown to twice the BSE's in 1994, though others estimate OTC turnover is three to four times the BSE's turnover. Some companies use the OTC because they are too small for the exchange or they prefer the OTC market's more lax disclosure requirements. Brokers prefer the less regulated OTC because they can set the market price for shares and charge commissions of up to 25 percent of the sale. Also the shortage of certified brokers does not impede their activities.

Regulation

Securities trading regulations are enforced by the Office of the State Securities Supervisor (SSS). Although modelled on the U.S. Securities Exchange Commission, the SSS has fewer enforcement rights. The SSS has full rights to control securities contracts and registration and to access files of broker companies. It must rely on the police, however, to investigate suspected violations. The SSS plans to work with the newly elected government to strengthen its investigative and enforcement powers.

Foreign Access to the Budapest Stock Exchange

Some restrictions are placed on foreign activity on both the BSE and the OTC market. Foreigners may not purchase state bonds without a special license, but they may freely purchase corporate paper or shares, provided payment is with a convertible currency. Specific restrictions are:

- Foreign buyers can exercise shareholder rights only if they have purchased registered shares. Should they purchase unregistered shares, they can seek to have the shares registered at the issuer's next general meeting, but the issuer can deny that right.

- Foreigners who want to purchase state bonds must be licensed to do so. In May 1994, the Ministry of Finance and the National Bank of Hungary jointly offered an issue of 15 billion forints in state bonds that came with an automatic license (i.e., foreigners could purchase them, a first in the Hungarian securities market). Initial foreign interest was extremely low, with only 100 million forints sold to non-resident investors. There are now three state security issues available to non-resident investors. Non-residents hold some 700 million forints in 3-year forint bonds and 1.4 billion in 1-year Treasury notes. In order to bridge the gap between domestic savings and the public financing requirement, the Ministry of Finance has proposed that a wider range of state securities be made available for purchase by non-resident investors. As of this writing, that proposal is awaiting action.

• Collectively, foreigners may hold up to 40 percent interest in an investment trust listed on the BSE.

• Foreigners purchasing securities must present convertible currency for the transaction. The right to convert dividends and cash on settlement into convertible currency, and to repatriate the proceeds, is unlimited. Withholding taxes on dividends and capital gains are 20 percent for both residents and non-residents. If a double taxation treaty exists between Hungary and the investor's country of residence, no withholding taxes are deducted.

Compensation coupons are issued only to Hungarians who can demonstrate that they had property seized either by the communist or fascist governments. There are no restrictions on foreigners buying compensation coupons in the secondary market. Of the uses to which compensation coupons can be put — the purchase of land from the state, housing, annuities or other property such as shares in state-owned firms — foreigners are restricted only in the purchase of land. However, in accepting compensation coupons for state property, the seller (the State Property Agency or the State Holding Company) can give priority to those who hold compensation coupons in "first right," i.e., those who are the original recipients of such coupons. The reduced usage rights to secondary holders is reflected in a lower price: whereas the coupons carry a property-exchange value of about 160 percent of the coupon's face value for "first right" holders, the coupons are currently trading on the secondary market at 56 percent of face value.

The Budapest Commodity Exchange

The Budapest Commodity Exchange was established on August 15, 1989 as the Produce Exchange Co., and began trading grains futures on October 25, 1989, six months before the first democratic election in Hungary. The BCE was the first, and to date is the only, operational futures market in the region.

Established as a private commodity exchange modelled after American commodity exchanges, the BCE is a non-profit, self-governing organization. The BCE has entered into special relationships with the Chicago Board of Exchange and the Chicago Mercantile Exchange, which, under a grant from the U.S. Trade and Development Program (now Agency), set out a plan ("Project 2000") for the BCE's long-term development.

In 1990, the BCE changed its name from the Produce Exchange to its present name. Present ownership is made up of 61 legal entities and 21 individuals; and includes banks, foreign trade companies, brokers, grain traders, and meat processors.

Foreign currency futures were introduced on March 16, 1993, with Hungarian forint contracts written against deutschemarks and U.S. dollars to allow businesses the opportunity to hedge currency risk. In January 1994, a Japanese yen contract was added. The BCE is currently

working on other financial derivative products; for example, an interest rate futures contract denominated in forints was being introduced in July 1994.

BCE trading volume has grown dramatically over the past five years. In 1993, total trade amounted to 12.329 billion forints, or about $123 million. The majority of this trade was in grains, which accounted for 10.660 billion forints or 86.5 percent of the total. (About 15 percent of the grain produced in Hungary traded through the exchange.) Trade in currency futures accounted for 1.447 billion forints in turnover, or 11.7 percent; trading in livestock, at 221 million forints or 1.8 percent, accounted for the remainder.

Currency futures are growing in importance. In the first six months of 1994, with overall activity on the BCE at some 7 billion forints, currency futures accounted for about 2 billion, or more than a quarter of all BCE trading, more than double its share of trading in 1993.

Prior to the passage of the Commodity Exchange Act by Parliament, the BCE's self-governing rules sought to provide investor protection. Those rules followed internationally recognized standards in regulating markets and protecting investors. With the passage of that act by Parliament in March, the State Securities Supervisor has assumed regulatory responsibilities for the market.

BCE floor rules require an exchange seat in each market for which privileges are desired: grains, livestock, currencies, and eventually energy. Trading is done through the open-outcry method. As with the Budapest Stock Exchange, payment and clearance is performed through the clearing house (KELER) described in the previous section. Earlier BCE rules had provided eligibility for membership to any individual or company, Hungarian or foreign, meeting certain financial and other criteria. The new law limits membership to companies registered under Hungarian law. The Exchange Membership Committee evaluates membership applications.

U.S. PRESENCE IN THE MARKET

Although there are no prohibitions against foreign company participation in either the stock or the commodity markets, U.S. presence is very limited. Major Western European banks have established trading subsidiaries with privileges on the BSE, but no U.S. bank or securities firm has established an entity for trading on either exchange. (Citibank holds a "suspended seat" on the BSE, but it has not yet established a legal trading entity that would allow it to activate that seat. It expects to do so in the future.)

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Local incorporation is required to participate in either the stock or commodities exchange. While there has been no relevant experience to date, after establishment U.S. firms would presumably be treated the same as domestic firms.

Foreigners may hold only a cumulative 40 percent interest in an investment trust listed on the Budapest Stock Exchange.

POLAND

BANKING

SUMMARY

The Polish banking system is going through a difficult period of adjustment. Only foreign-owned banks are considered to be healthy. The large state-owned banks are burdened with bad debts to state enterprises. These state-owned banks, however, are the beneficiaries of government programs to clean up their balance sheets and help in their recapitalization. Private domestic commercial banks, founded in large numbers in 1990 and 1991, also are troubled. Regulators licensed many private banks during that period without ensuring management capability or adequacy of financial resources. Subsequently, these banks amassed portfolios of bad loans due to poor lending practices. Many of these banks are probably not viable and will either be closed or merged with healthy institutions.

The National Bank of Poland (NBP) does not appear to have resolved what role it wants foreign banks to play in Poland and for a period of time ceased issuing foreign bank licenses. However, in September 1993, the NBP issued a license to a joint venture of Dresdner Bank (Germany) and the National Bank of Paris (France). The NBP has expressed a preference for foreign banks to enter the Polish market by purchasing troubled Polish banks, indicating that from a regulatory standpoint this would be the easiest way to enter, because no new license would be required. The NBP also expressed its readiness to provide financial assistance to deal with the problems of the acquired bank. Following the conclusion of a debt reduction agreement between Poland and the London Club, foreign commercial bank interest in Poland has increased, and a number of banks are negotiating for the purchase of ailing Polish banks.
Although one foreign bank (non-U.S.) has established in branch form, the NBP has indicated that it will not approve any more branch applications. Citibank is the only U.S. subsidiary bank operating in Poland. It began its operations in 1991. As an incentive to operate in Poland, it was granted three tax holidays during its early years. However, changes in the foreign investment law designed to place domestic investors on an equal footing have repealed these and many other incentives for foreign investment.

Foreign banks are subject to the same regulations as domestic banks. There are no special restrictions or constraints imposed on foreign banks with regard to the products they can offer or in their funding activities. Regulatory transparency, especially in the licensing process, is an area of concern. Nevertheless, foreign banks are able to communicate their concerns to the authorities.

DESCRIPTION OF MARKETS

The Polish banking system is undergoing the growing pains of transforming to a market-oriented economy.

National Bank of Poland

The National Bank of Poland (NBP) now functions as a typical central bank. It issues currency, holds official foreign exchange reserves, refinances the banking system, and supervises the commercial banks. Until 1989, however, most banking services in Poland were provided by the NBP, functioning both as a central bank and as a commercial bank. It controlled over 65 percent of business and household banking transactions. Most of the NBP's lending was to state-owned enterprises, in line with the requirements of the government's economic planning. Poland also had six other banks, each performing a specialized function.

In 1989, the nine commercial lending arms of the NBP became independent banks. In 1991, following the collapse of Poland's trade with the former Soviet Union, the Ministry of Finance commissioned an audit of the nine banks' portfolios, which revealed a very high percentage of problem loans. The percentage of bad loans for all of the banks — except Bank Slaski (BSK) and Wielkopolski Bank Kredytowy (WBK) — increased an average of 15 to 20 percent, to 40 percent, between the end of 1990 and June 1991. Setting aside reserves for these loans would have resulted in a substantial decrease in the capital of these banks, dropping their capital adequacy ratios to well below the 12 percent level required by Polish banking regulations. To respond to these concerns, the Ministry opted for an approach designed to compel the banks to take action swiftly with respect to the bad debts. In 1992, each of the banks set up, at Ministry of Finance insistence, "work-out" departments to manage the bad debt portfolio. These departments, staffed largely from outside existing loan departments, were intended to either restructure or dispose of the loans. However, their task was hindered by the limitations of existing law. Banks could avoid court bottlenecks through creditor-driven out-of-court debt restructuring only with the approval of 60 percent of all creditors holding 75 percent of a borrower's debt.

In 1992, the nine commercial banks were transformed into joint-stock companies with the intention that they would be subsequently privatized. To date, only two have been privatized: WBK in April 1993 and BSK in December 1993.

Today, banking in Poland is going through a consolidation phase, even though levels of service and products offered are still developing rapidly. As of June 30, 1993, there were 73 banks in Poland (13 state-owned and 60 private).

State-Owned Banks

As noted above, the remaining seven state-owned banks (originally there were nine) were spun off from the NBP, with only the two healthiest banks being privatized. All of the seven state-owned banks are Treasury-owned and burdened with bad loans to state enterprises. Present

Polish government plans, which call for providing $875 million for balance sheet clean-up, should help to restore these banks to health.

The seven former specialized banks, although now organized as universal commercial banks, still concentrate on their former lines of business. Only Bank Handlowy, the former foreign trade bank and Poland's largest bank, is profitable. The other banks include some of the banking sector's most intractable problems.

Privately Owned Banks

The 60 privately owned banks include the two banks spun off from the NBP and 13 foreign-owned private banks. The foreign banks comprise the only strong part of the banking sector. Strong management, better services, and tax holidays have enabled these banks to be highly profitable and to experience rapid growth.

A significant number of the other private banks were licensed from 1990 to 1992. During this period, it was relatively easy to obtain a banking license from the NBP, and a large number of small private banks were established. It is now apparent that licensing standards during that period were too lax, as many of these banks were undercapitalized and badly managed. Many have loan portfolio problems because of inept or dishonest lending practices. According to the president of the NBP, at least 15 qualify for closure.

Cooperative Banks

In addition to these commercial banks, there are 1,636 rural cooperative banks. These financial institutions provide banking services to rural communities. About 1,200 of them belong to the Bank for Food Economy, and the remainder belong to four regional banks. The cooperative banks are in a particularly perilous financial condition. Although they represent a small portion of the banking system (8 percent of loans by commercial banks), they are the principal source of banking services for the one-third of Poland's population that lives in rural areas. Together with the Bank for Food Economy, relief for the cooperatives is an important political issue for Poland's influential farm lobby.

State of the Banking System

The following table prepared by the NBP gives a picture of the health of the banking system as of November 1993.

Polish Banking System (in ZL trillion, unless otherwise stated)	
Loans granted	327.1
Of which, "dead," requiring reserves	49.3
"Dead" loan reserves (specific reserves — 48 percent)	23.7
Missing "dead" loan reserves (Reserves not yet established)	25.5
Current balance sheet profit	21.1
Current balance sheet loss	10.4
Accrued balance sheet loss	16.3
Total losses (accrued plus missing reserves)	41.8
Capital (total own funds)	63.7
Total losses as share of capital (percent)	65.6
Total deposits	443.5

Note: These are selected items chosen by NBP to illustrate the poor situation of the banks. It is not a balance sheet and the numbers do not sum. "Dead loans" are substandard credits.

Restructuring Efforts

In 1993, the Polish government enacted a law on the financial restructuring of enterprises and the ability of banks to deal with the problem of bad debts between state-owned enterprises and state-owned banks. The 1993 law offered a two-pronged approach to restore the state-owned banks to health. The first element was to rid the banks of nonperforming loans. The second element was to recapitalize the banks to restore capital adequacy ratios to world and Polish prudential standards. In 1993, the GOP recapitalized the seven state-owned banks through the issuance of ZL 11 trillion of recapitalization bonds (the interest and principal on these 15-year Polish treasury securities will be paid from the former zloty stabilization fund, which the U.S. and other governments established, after privatization of the banks begins). The amount of recapitalization each bank received was determined by the amount of bad loans in the bank's portfolio, plus any additional capital needed to raise the bank's capital/assets ratio to 12 percent.

The 1993 law gave the banks' work-out departments a new legal framework without the previous constraints, but with a deadline to complete the process for pre-1992 debt. The new law directed banks to choose one of three options for each of the bad loans identified in the 1991 audit: (1) execution of a "conciliation agreement" with the debtor and other creditors, under which all the firm's debt was restructured (similar to "Chapter 11" reorganization under U.S.

Bankruptcy Law), (2) sale of the debt at auction, or (3) commencement of liquidation proceedings against the debtor.

Ministry of Finance regulations issued for implementing the 1993 law set a March 31, 1994, deadline for resolution of the seven banks' bad debts. However, on March 31, the Finance Ministry extended the deadline for conciliation agreements to April 29, and the deadline for the sale of debt until April 24. There are indications that the Finance Ministry may also relax the requirement to commence liquidation proceedings for those debts not disposed of. The press reported that on April 1 that the Ministry had proposed to transfer the debt of 38 firms from banks to the Polish Industrial Development Agency (IDA). The results of this exercise are still not known.

The restoration to health of the seven banks is not the final goal, but a step in the GOP's plan to privatize the banks. Nevertheless, despite the recapitalization and the expiration of the March 31 deadline, progress in bank privatization has been slow. The privatization process is being undertaken by the Ministry of Finance in cooperation with the NBP, IBRD, IMF, and IFC. Actual ownership transformation is the final element in the privatization process, following commercialization and balance-sheet clean-up. Current plans call for 30 percent of shares to be held by the Treasury, 5 percent to be sold to the employees of the bank, and the remainder to be divided between a public offering and a strategic investor. To date, two of the nine ex-NBP banks have been privatized in this manner and are listed on the Warsaw Stock Exchange. The six specialized banks also were commercialized. Although they became universal banks after commercialization, they are still heavily engaged in the lines of business in which they previously specialized.

Under present legislation, only the former state-owned banks are covered by deposit insurance, but the NBP provides insurance coverage for the deposits of natural persons in private banks up to ECU 3,000. The provision for deposit insurance coverage for private banks is based upon a policy statement issued by the NBP last year to prevent a run on private banks.

U.S. PRESENCE IN THE MARKET

Citibank, which is the only U.S. bank subsidiary operating in Poland, began its operations in 1991. It concentrates on corporate banking. Citibank quadrupled capitalization in the last three years. During its first three years of operation, the government offered Citibank tax holidays from the 40 percent corporate income tax. Citibank has its main office in Warsaw and a branch in Gdansk.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The main issue of treatment in Poland is the licensing of new banks. Polish law permits foreign banks to operate either as subsidiaries, branches, or representative offices. However, prudential limits for branches are based upon local paid-in equity, not the parent bank's equity, effectively removing much of the rationale for establishing a branch. Moreover, the NBP has indicated it does not intend to issue any more licenses for foreign banks to establish in branch form. In practice, no new bank licenses were issued from 1992 to September 1993. The one recent exception was the issuance in September 1993 of a joint venture license for Banque National de Paris (France) and Dresdner Bank (Germany). The national bank has been equally reluctant to license new Polish banks.

The NBP has expressed a preference that foreign banks enter the Polish market by purchasing troubled Polish banks. It says that from a regulatory standpoint this would be the easiest way to enter because a new license would not be required. This reflects the NBP's belief that there are already too many banks in Poland (largely because of the indiscriminate issuance of licenses to Polish private banks in 1990-1991) and the desire to have foreign banks help with consolidation and clean-up of the many troubled Polish banks. The NBP is willing to provide assistance with the acquisition of troubled Polish banks.

Foreign banks did not welcome this policy when it was announced in 1993, and as of June 30, 1994, only two foreign banks have invested in Polish banks. The Dutch ING Bank bought 25 percent of Bank Slaski, and the German Commerzbank had announced plans to buy 25 percent of BRE. Both of these were relatively healthy Polish banks. No foreign bank has yet agreed to take on the NBP's problem banks, although Deutsche Bank and ABN Amro recently submitted offers to acquire an ailing institution.

Bank licenses are issued by the president of the NBP in consultation with the Minister of Finance. A new bank subsidiary may be established if it meets the following capital requirements:

- The minimum capital in convertible currency to be brought in by foreign participants is $6 million;

- The bank's initial capital may not originate from a loan or line of credit;

- The president of the bank's board of directors is to be appointed after consultation with the NBP. The NBP's role is purely advisory; it renders an opinion but cannot block the appointment. The NBP is merely notified of the appointment of other bank officials.

While there is no limit placed on a shareholder's maximum stake in a subsidiary bank's capital, there is a series of thresholds for reporting acquisitions and receiving approval from the NBP.

There is no effective barrier to sub-branching by foreign-owned banks. Foreign-owned banks concentrate on commercial clients and are not currently interested in extensive branch networks. The tax holidays that helped Citibank to become so profitable in its first years in Poland will not be repeated. Changes in the foreign investment law have repealed these tax holidays and many other incentives for foreign investment, creating a level playing field for all investors.

There are no special restrictions on the products that foreign-owned banks can offer or constraints on their funding activities.

Foreign financial institutions have expressed their concerns regarding regulatory transparency, particularly with regard to the licensing process. Nevertheless, it is clear that they are able to communicate their concerns to the authorities, and at times, legislation has been undertaken on their behalf.

Balance Sheet of the Polish Banking System
December 31, 1993
(ZL Billions)

Assets:	TOTAL	NBP	COM.
Total Foreign Assets	261,349	134,876	126,473
In Convertible Currencies	226,249	101,124	125,125
Included in Reserves	218,188	100,870	117,309
Gross Official Reserves	91,370		
Other Assets Included in Reserves		9,509	
Not Included in Reserves	8,061	245	7,816
Other Assets	35,100	33,752	1,348
			116,891
Receivables from the Financial Sector	180,266	63,375	
Global Receivables	180,266		
Bank Vault Cash	22,006		22,066
Other Receivables	158,260		
NBP Obligations	45,811		45,811
To Banks and Post			49,074
Total Refinanced Credits		47,208	
Basic Credits		2,542	
Central Investment Credits		27,633	
Current Acct. Credits		12,574	

Assets (cont.):	TOTAL	NBP	COM.
Rediscount Credits		3,514	
Lombard Credits		47	
Auction Credits		0	
Other Credits		897	
Other Receivables		16,167	
Receivables from Budgetary Sector	38,063	18,660	19,404
From Central Government	37,278	18,645	18,634
From Local Governments	785	15	770
Receivables from Non-Bank Public	331,957	268	331,689
From Businesses	309,363	58	309,305
From Households	22,594	210	22,385
Securities	320,947	138,876	182,072
Treasury Bills	168,445	83,063	85,382
Treasury Bonds	143,561	55,556	87,995
In Foreign Currency	119,179	31,184	87,995
Other Securities	8,941	246	8,695
Other Assets	169,434	29,632	39,802
Total Assets	1,302,017	385,687	916,331

Liabilities:	TOTAL	NBP	COM.
Total Foreign Liabilities	88,209	56,839	31,370
Foreign Liabilities Included in Reserves	31,324	14,185 43	17,139
Short-Term Reserve Liabilities	14,142	14,142	
IMF Credits			
Other Foreign Liabilities	56,885	46,654	14,231
Liabilities to the Financial Sector	157,912 62,657	44,639 0	113,273 62,657
Liabilities to NBP	95,255	44,639	50,616
Liabilities to Banks/Post		31,941	
Compulsory Reserves		5,824	
Current Account		6,873	
Other Liabilities			
Government Deposits	49,780	22,721	27,059
Central Government	22,924	11,284	11,640
Local Government	11,489	0	11,489
Non Budget Funds	15,368	11,438	3,930
Cash in Circulation (including vault cash)	121,830	121,830	0
Zloty Deposits of the Non-Bank Public	298,514	100	298,413
Demand Deposits	96,650	100	96,550
Of Businesses	82,589	100	82,488
Of Households	14,062	0	14,062
Savings	11,488	0	11,488
Time Deposits	190,676	0	190,376
Of Businesses	53,270	0	53,270
Of Households	137,106	0	137,106

Liabilities (cont.):	TOTAL	NBP	COM.
Hard-Currency Deposits of the	160,907	101	160,806
Non-Bank Public	46,974	80	46,985
Demand Deposits	113,932	21	113,911
Time Deposits	5,045	0	5,045
Of Businesses	108,887	21	108,866
Of Households	10,282	7,321	2,961
Securities in Circulation	274	0	274
Credit Liabilities	52,712	2,100	50,612
Principal and Reserve Funds	361,597	130,035	231,563
Other Liabilities	1,302,017	385,687	916,331
Total Liabilities			

[1] NBP bills denominated in foreign currencies.

Note: ZL 21,079 equalled U.S.$1 on December 31, 1993. Numbers may not sum due to rounding.

POLAND

SECURITIES

SUMMARY

Securities markets are in their infancy in Poland. Activity is centered in the Warsaw Stock Exchange (WSE), which has been trading securities since 1991. The WSE experienced a boom in 1993 and the first two months of 1994, as it gained international recognition as an emerging market and local small investors entered with hopes of quick profits.

The sole securities market regulator is the Polish Securities Commission.

Currently, only two U.S. firms are operating in Poland. The Pioneer Fund has established Poland's only mutual fund. Although experience is limited to date, U.S. firms do not appear to face discriminatory impediments to entry or operation. The Pioneer Fund has had a role in developing legislation related to its operations.

DESCRIPTION OF THE MARKET

Regulation and Structure[1]

The Public Trading in Securities and Trust Funds Law was adopted by the Polish Parliament on March 22, 1991 (amended on October 9, 1991, and again in January 1994). This law created the Polish Securities Commission (KPW, or Commission)) as the sole government agency responsible for regulating the developing securities markets in Poland. The law was developed in consultation with regulators from the U.S. and Europe. EU Directives and recommendations of the Group of Thirty were taken into account. The WSE was developed in partnership with the Societe des Bourses Francaises.

The Commission approves stock issues for public trading; it also licenses brokerages, and securities industry professionals (financial advisers as well as brokers). Once licensed by the KPW, a brokerage may also deal in securities. With respect to underwriting, there are no official regulations; technically, anyone in Poland can underwrite securities issues. However, securities issues are usually underwritten by syndicates of financial and non-financial firms. For example, the industrial corporations Electrim and Polifarb-Cieszyn recently joined syndicates that underwrote each other's stock issues.

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[1] This section incorporates excerpts from a USAID-funded study, "Review of the Status of the Polish Capital Markets," prepared by Financial Services Ltd.

The Commission also oversees public trading to ensure that rules of proper trading procedure and competition in the trading securities are obeyed. In order to enhance its own regulatory oversight, the Commission works in concert with brokerage firms, establishing and monitoring self-governing rules for the industry and a code of conduct for brokers and financial advisors.

The Commission recently approved changes to its prospectus requirements to bring local practices into conformity with international standards. Among other things, the new rules will allow foreign issuers of securities in Poland to provide statements audited in accordance with international auditing standards.

The Bond Market

The Act on Bonds, completed in September 1988, establishes the rules for private bond issuance, sale, acquisition and redemption. The act also authorizes the following entities to issue bonds: the State Treasury, legal persons, local authorities, social organizations (which have a legal personality and conduct economic activity apart from their statutory roles), and foundations (which are organized to conduct economic activities). Bond issuance may be conducted through public offering or by private placement. Two kinds of bonds may be issued, both of which are fixed yield and may be underwritten by anyone: registered bonds and bearer (coupon) bonds. There is no secondary market for corporate bonds (of which there are very few).

The Equity Market

A stock exchange was first founded in Warsaw in 1817. By 1939, there were six exchanges in Poland, although Warsaw accounted for 90 percent of securities trading. All six exchanges, however, were closed at the outbreak of World War II and never re-opened by the post-war communist government. Therefore, when Poland began implementing economic reforms in 1989, it began with essentially undeveloped domestic capital markets.

The center of the Polish securities industry is the Warsaw Stock Exchange (WSE), which has been in operation since April 1991. The WSE is the secondary market for Polish government securities.

Few stocks have been floated on the WSE because most firms seem to be daunted by the process of raising money via the exchange. Particularly, a lack of transparency in underwriting procedures has been cited as a problem. The regulatory authorities have been urged to undertake initiatives to clarify and strengthen these procedures.

When the WSE opened on April 16, 1991, seven brokerage firms traded the shares of five companies. Turnover on the first day was $2,000. During the next 18 months of operation, the WSE attracted little investor interest, but in 1993, trading on the exchange took off, recording

tenfold growth in the WIG index. By the end of 1993, turnover per session had risen to $62 million.

By early 1994, however, perceptions had grown that the market was overvalued. Although it continued to rise until the end of February, the market underwent a correction, losing half of its value by mid-April. The volatility of the market stems in part from the participation of many very small investors who have tended to put their life savings into the WSE in the belief that it offers a substantial, guaranteed return. During the correction, these investors panicked after experiencing the market's downside risks.

The Polish authorities encourage foreign investment in the WSE and hope that continued foreign investor interest will contribute to growth of the market. In the past, most foreign investment has been short-term, but some institutional investors have expressed an interest in the longer term. However, the small size of the market and its lack of liquidity has tended to dampen foreign investor enthusiasm.

Brokerage Firms

As of January 1994, 37 brokerage firms had been granted operating permits by the Securities Commission. A firm may not legally operate a stock brokerage business in Poland without a permit. In order to obtain a license, a firm must submit details about the extent of its activities and its ownership structure and management (including certification that these persons have no criminal record nor have they been charged with dishonest acts). The firm must also submit details of its organizational structure and technical facilities to demonstrate its own independent capacity to conduct business, apart from the support of any parent firm. Firms that are fully or partially foreign-owned are allowed to apply to the Securities Commission for operating permits provided that such firms are already legally registered in Poland.

Unlike the United States, there are no restrictions on banks to undertake brokerage activities, provided that their securities operations are both organizationally and financially separate from their banking operations.

Individual Brokers

As of March 1994, there were approximately 419 individuals who had been granted brokerage licenses by the Commission. These brokers must successfully pass the examination set by the Securities Commission, which tests a candidate's knowledge of, and suitability to engage in, securities trading. The examination is considered to be difficult (those in a position to compare say that it is more difficult than the Series 7 examination in the United States), and only 13.2 percent of candidates taking the exam have received a passing grade.

Trust Funds

Trust funds may be managed only by trust fund corporations supervised by the Commission. The charter of the trust fund corporation is limited. It is restricted to the investment and management of fund assets. The charter of the corporation, the by-laws of a fund, and the selection of the custodial bank are subject to joint approval by the Commission. Any change in the charter, the by-laws, or bank selection also requires the Commission's approval. As of January 1994, only the Pioneer First Polish Trust Fund had been granted an operating permit.

Investment Advisers

Only two people passed the first investment adviser licensing exam, administered in mid-November 1993. Five more passed the second exam, administered in February 1994. Investment advisors may provide advice and recommendations to customers — services that brokers currently cannot offer in Poland. (Brokers are currently restricted to only executing and processing client orders.)

Pension Fund Regulation

Under the auspices of the Securities Commission, a special inter-ministerial working group began discussions in November 1993 with the mandate of studying and developing the institutional and regulatory framework for creating and operating a pension fund management industry in Poland. It is uncertain when the group's work will be completed, and until a law is enacted, a private pension fund cannot be legally established in Poland. A representative of the Pioneer First Polish Trust Fund, the first and only publicly traded mutual fund in Poland, was invited to participate in the working group as an observer.

Capital Movements

Although there had previously been restrictions on foreign purchases of some early series Polish government securities, these restrictions have been phased out and do not apply to more recent issues. There is no shortage of government securities available to foreign buyers.

There are no restrictions on foreign purchases of minority stakes in publicly traded Polish corporations, other than disclosure requirements that apply to all buyers. For firms that are not publicly traded, there are laws, however, that regulate foreign ownership of certain assets (real estate) and types of firms (firms owning real estate or trading in strategic sectors). Foreign investors need to obtain a permit from the Ministry of the Interior for investment in firms owning real estate, and from the Ministry of Privatization, for firms trading in strategic areas.

Poland maintains controls on the movement of capital and outward investments. All capital transactions, as well as all foreign credits (over $1 million) to be used for the purchase of goods

and services abroad, require approval from the Central Bank. This means that for Poles to purchase foreign securities, they must first obtain Central Bank approval for the transfer of capital abroad. A foreign share offering — or an ADR program — requires the approval of the Exchange Commission. The first offering of an ADR by a Polish enterprise is currently under preparation.

New Products

The Securities Exchange Law provides for trading in derivatives, but the Exchange Commission has yet to prepare the necessary implementing regulations, so it is still not possible to introduce these products. In fact, the introduction of derivatives is actively discouraged by the WSE and the Commission, and as a result, no firm has attempted to introduce a derivative product in Poland.

Similarly, the introduction of other new securities products remains hypothetical given the present degree of development of Polish capital markets. For example, a forward market in foreign exchange has yet to be established, due in part to the dearth of counterparties interested in hedging zloty risk.

U.S. PRESENCE IN THE MARKET

Citibank is a primary dealer in Polish Treasury securities, and it is reportedly planning to establish a stock brokerage firm in Warsaw. Other U.S. firms are said to be interested in entering the market, but to date, none have done so.

The Pioneer First Trust Fund was established by the Pioneer Group of Boston in July 1992. The fund manager, the Pioneer First Polish Trust Fund Joint Stock Company, is wholly owned by Pioneer International Corporation. The only publicly traded mutual fund in Poland, Pioneer has grown rapidly over the past year.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Securities firms must be legally registered in Poland in order to conduct business.

Pioneer and Citibank have not experienced difficulties entering or operating in Poland's securities markets. As noted above, the Polish law on mutual funds was written to accommodate Pioneer's business activities. In addition, a representative of Pioneer is an observer on the working group to develop pension fund regulation.

There are no restrictions on foreign purchases of government securities or minority stakes in publicly traded Polish corporations, although investment in certain types of assets and certain firms that are not publicly traded are subject to well-defined restrictions.

Exchange Rates

Average 1993:	US$1 = 18,115 Zlotys
End of year 1993:	US$1 = 21,334 Zlotys

RUSSIA

BANKING

SUMMARY

The commercial banking system in Russia is only five years old, but it has progressed and developed rapidly over the last two to three years. The 20 to 30 largest banks are approaching Western capital standards and are offering a full range of banking services. However, the rapid evolution of the market has made it difficult for the central bank and other participants to keep up with the trends and changes in market practices. There are now over 2,000 registered commercial banks in Russia, most of them established since 1991. About one-third of the banks are vestiges of the old state banking system; the rest were created de novo. Many of these banks are small; only 10 percent have a capital base exceeding $1 million. Many were founded by enterprises as an expedient way to draw directed central bank credits, and many still have only one large depositor and borrower (the enterprise that founded them).

Because the banking system in Russia is undergoing such a dramatic transformation, it is suffering from growing pains that temper the full trust and confidence of the populace. The absence of legislation against fraud and false advertising, allegations of ties to organized crime, inadequate capital and accounting standards, insufficient resources for bank regulation and supervision, and an inefficient payments system are all barriers to a successful transition to a market system based on safety, soundness, and prudential concerns for depositors. Legislation is currently being either drafted or contemplated, but it will be several years before it can be fully implemented.

Although foreign-Russian joint venture banks started in 1989 and 1990, wholly-owned foreign bank subsidiaries have been established only since 1993. In 1993, ten foreign banks, including two from the United States, received licenses from the central bank to establish subsidiaries. However, by the end of the year only four foreign banks, representing Austria, Germany, China, and France, had actually established a presence. Two U.S. banks, Citibank and Chase Manhattan, established subsidiaries in 1994. Two other U.S. banks have set up representative offices, and others are considering expanding their operations to Russia.

In November 1993, a presidential decree imposed a moratorium until January 1, 1996, on all foreign bank operations with Russian residents, unless the bank was "already servicing residents" before the decree was issued. In June 1994, another presidential decree eased the restrictions for European banks by lifting the moratorium on existing licensed banks from those countries that have a bilateral investment treaty in force with Russia.

Foreign banks in Russia face other discriminatory treatment, such as aggregate limits on foreign bank capital in the Russian banking system and different minimum capital requirements from those imposed on domestic banks.

In addition, under Russian banking law, enterprises are restricted to only one ruble bank account; companies may not open additional accounts with a foreign bank unless they close their existing account with their "house" domestic bank, with the house bank's approval. This regulation effectively serves as a significant barrier to expanded business by foreign banks.

DESCRIPTION OF THE MARKET

As in other formerly centrally-planned economies, the existence of a private commercial banking system in Russia is relatively new. In the former Soviet Union, the banking system was integrated with the central bank, known as Gosbank. The banking system served as a conduit for the collection of household savings into the state budget. Credits to industry were issued directly from the state budget, through Gosbank or its entities. Gosbank performed auditing functions to ensure that the funds were used according to plan. Additionally, Gosbank conducted all state and "commercial" banking operations. The state had two integrated, specialized banks to assist it: Vneshtorgbank USSR (VTB — the Foreign Trade Bank), which financed foreign trade, serviced external debt, and handled foreign exchange transactions; and Stroybank USSR (the Bank for Construction), which funneled central bank credits to industry.

On January 1, 1988, there was a major administrative reorganization of the Soviet banking system. Sberbank USSR (the Savings Bank), which held and transferred household deposits, was formed from the savings department of Gosbank. "Commercial" operations of the Gosbank were spun off to create additional specialized sectoral banks: Agroprombank USSR (the Agricultural and Industrial Bank); Zhilsotsbank USSR (Bank for Housing and Social Development); Vnesheconombank or VEB (the Bank for Foreign Economic Relations to handle the financial activities of the Vneshtorgbank), and Promstroybank USSR (the Industry and Construction Bank, succeeding Stroybank).

In mid-1988, Viktor Gerashchenko, then chairman of Gosbank, unexpectedly allowed the establishment of private banks. New sectoral banks were formed. Many enterprises found it expedient to form their own in-house commercial bank, which could more easily obtain central bank credits directed to industry. The specialized state banks also were converted into private companies, although the state retained ownership interest. Many local central bank and specialized bank branch offices were simply taken over by the managers, and many of today's Russian banks were founded by this method. The period 1990-91 saw a virtual explosion in the number of commercial banks. The free convertibility of the ruble for businesses in August 1991 and for individuals in July 1992 led to a lucrative foreign exchange business for the banks. As a result, the number of commercial banks surged from about 250 in mid-1990 to over 1,500 by the end of 1991.

On December 31, 1991, the Soviet Union was dissolved, and specialized banks underwent a transformation. Most of the assets of Sberbank USSR and Promstroybank USSR were

transferred to their Russian counterparts of the same name. Zhilsotsbank USSR was dissolved, and Mosbusinessbank emerged with the bulk of the assets. Uncombank was also formed from part of Zhulsorsbank's assets. Rosselkhozbank (Agricultural Bank of Russia) succeeded Agroprombank (Agricultural Industry Bank), and on January 1, 1994, changed its name to Agropromstroybank. VEB ceased to function, having frozen its hard currency deposits, and its commercial banking operations were taken over by Vneshtorbank (VTB). VEB remains a fully-owned state bank and acts as an agent of the government in foreign debt negotiations while the Finance Ministry pays off the bank's debts.

Current Situation

Today, there are over 2,000 registered banks in Russia,[1] only a third of which were derived from the old specialized banks.[2] Only about 50 banks, however, offer customer services that are up to Western standards. Most of the rest are very small and offer only limited services. Almost two-thirds of the banks have capital less than Rbs 500 million,[3] and only 2.5 percent of the banks have capital over Rbs 5 billion. The largest banks in Russia are still the three former state banks: Sberbank, Agropromstroybank, and Vneshtorgbank. Sberbank, with over Rbs 63 trillion in capital, has 40,000 branches in Russia, Agropromstroybank has another 1,000 branches, and all the remaining commercial banks have about 3,000 branches. Sberbank accounts for the bulk of household deposits, although the share is declining. On January 1, 1993, it accounted for over 90 percent of all household deposits, but one year later, its share had dropped to 60 percent.[4]

The geographic distribution of banks is also distinctive. Banks are spread unevenly across Russia. Moscow, which accounts for less than 10 percent of Russia's population, has almost 40 percent of its banks.[5]

Besides the specialist banks and the commercial banks, cooperative banks also exist in Russia, but they are in a nascent state. The Canadian cooperative savings bank, Desjardins, announced that in 1994 it will help to establish a larger network of Russian savings and cooperative banks.

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[1] Actual totals were 2,018 as of December 31, 1993, and 2,436 as of October 1, 1994, according to CBR.

[2] Financial and Business News, March 1994, #10.

[3] About $400,000. All ruble figures in this report are as of January 1, 1994, unless otherwise stated. The ruble exchange rate for December 31, 1993 was Rbs 1,247 per dollar.

[4] Financial and Business News, March 1994, #10.

[5] Ibid.

The ownership structure of banks in Russia tends to be diverse. Almost all banks are now joint stock companies. The very large banks are widely held, although the state, through the Central Bank of Russia (CBR) or the State Committee on the Management of State Property (GKI), still retains significant equity interest in a few former specialist banks. By law, the CBR holds a major share in VTB and a controlling interest in Sberbank. The very small banks, on the other hand, tend to have highly concentrated ownership. The formation of "financial-industrial" groups, proposed in 1993 by the Prime Minister, in which vertically integrated companies own an in-house bank, may make this ownership concentration become more prominent. As noted earlier, enterprises established banks initially as a way to obtain direct central bank credits, and the practice of connected or insider lending to shareholders continues.

Services

Commercial banks in Russia now offer a wide range of services, with some banks providing services similar to those in the West: deposit taking (current and time); transfers/payment orders and other cash services; commercial and personal lending; project financing; factoring, leasing, and forfeiting; and foreign exchange operations. Commercial banks in Russia also are universal banks and can trade in equity and debt instruments both on their own account and as an agent, perform investment banking operations, offer trust services, and provide investment and business consulting. Foreign exchange assets account for about one-half of banks' aggregate balance sheet; loans comprise about one-third of the assets. On the liability side, about 20 percent of the funding comes from the interbank market, and another 30 percent from corporate accounts,[6] with the remainder coming from household deposits.

Clearance and Settlement

Although there have been improvements since early 1993, the payments, settlements, and clearance systems in Russia are still not satisfactory. In general, improvements are being made to official clearing channels and, at the same time, private clearing arrangements are reported to be expanding rapidly. Eleven time zones and a large geographical area complicate the establishment of an adequate clearing system. Electronic data processing and communications facilities are being installed within the official CBR clearance system. However, a large number of the clearings and settlements through official channels still rely on paper-based arrangements at the numerous CBR "cash settlement centers" across Russia. In major financial centers, the settlement of paper items may still take several days, which inhibits the development of efficient money markets. Delays in interregional clearings and settlements that result from traditional clearing methods may also inhibit the development of nationwide markets for government and private securities. The CBR is engaged in the development of a nationwide electronic payment system and senior CBR officials predict that such a system will be fully operational within a few years. To assist in the development of this system, as well as other payment system reforms,

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[6]Ibid.

the CBR has established and chairs an International Steering Committee of international advisors and commercial bankers, including the Federal Reserve System, central banks of several European countries, the IMF, the World Bank, and the European Bank for Reconstruction and Development (EBRD).

The private sector has continued to develop alternatives to clearance and settlements through official channels. Commercial banks increasingly offer correspondent accounts through which interbank payments may be cleared and settled electronically. For example, Tveruniversal Bank claims more than 400 banks as members of its private payments system. Often, banks using electronic systems can clear money transfers among themselves in major cities within one day. In addition, at least two private clearing houses were granted licenses to begin operations in 1994[7].

Cross-border, international financial transactions are now feasible. According to the Central Bank, over 100 Russian banks are members of SWIFT. Thus, standardized electronic, international banking communications are now possible between a significant number of Russian banks and banks in other countries. These communicating methods, coupled with international correspondent banking relationships, provide the infrastructure for conventional international banking transactions. In addition, U.S. and other foreign banks operating in Russia have the potential to augment and deepen the available settlement arrangements in Russia for international transactions, as Russia develops an international banking sector that is similar to those in other countries.

At the retail level, Russia remains largely a cash society. Individuals do not widely use payment orders or checking accounts. Credit and debit card usage is at an early stage, and incompatible settlement systems complicate matters. It is estimated that only some 300,000 Russian enterprises and individuals hold cards issued from all sources.[8] According to some reports,[9] only 14 Russian banks offer foreign credit cards such as MasterCard and Visa, and only a few more Russian banks offer their own credit and debit cards. The most popular Russian bank cards include STB-Card, UnionCard, and the United Payment Systems card. STB-Card was originated by Stolichny Bank and, as of February 1994, was issued by 15 Russian banks.[10] UnionCard was created by Avtobank and Inkombank and is expected to be issued shortly by up

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[7] The Interbank Finance house and the Moscow Clearing Center. The Urals Financial Group is applying for a license.

[8] Delovye Lyudi, April 1994, p.26

[9] BISNIS BULLETIN, U.S. Department of Commerce, Dec. 1993/Jan. 1994

[10] Delovye Lyudi, April 1994, p.27

to another 13 banks.[11] Several large and separate credit card settlement companies exist in Russia: one for the STB-Card; CardCenter, founded by Most Bank, Dialog Bank, and Credit Moscow Bank, which services MasterCard and Visa; American Express-Russia for its own cards; and United Credit Cards Company, founded in 1993 and run by Most Bank and Credobank, which services foreign cards and the UnionCard. Generally, to avoid risk, banks require credit card applicants to deposit collateral equal to the credit limit, limiting the universality of credit cards.

ATMs

Automated teller machine (ATM) networks also are at an early stage of development. American Express has had two ATMs in Moscow since 1989. The first ATM network linking Russian banks to the worldwide Cirrus system opened in March 1994. Brussels-based Europay International, together with nine Russian banks (including Most Bank and Credit Moscow Bank), initiated the project and plans to operate ten ATMs in Moscow by the end of 1994. The ATMs will accept Eurocard, MasterCard, and local ATM bank cards. However, the quantity of the latter slated for circulation will be low this year — only about 2,000. Dialog Bank also plans to set up about 40 ATMs in 1994. Therefore, it is now possible through the ATM networks for someone in Russia to withdraw rubles and dollars from a U.S. bank account and for someone in the United States to withdraw dollars from an account in Russia.

Fraudulent Practices

There has been recent high-profile public attention paid to criminal and fraudulent activity in the banking sector. This activity and the perception of it has serious implications for the safety and soundness of the banking system and consumer confidence in the commercial banks as an integral institutional component of a market economy. There are many facets to the problem. First, in the past, there were no laws against false and illegal advertising in the financial services sector. One could see fraudulent advertising of banks offering several thousand percent interest on ruble deposits and 40 to 50 percent on dollar deposits. Central bank and finance ministry officials recognize the problem, and on June 10, 1994, President Yeltsin issued Decree Number 1183 to prohibit false advertising. The Duma is currently considering draft legislation to address the problem.

Second, there has been substantial press coverage on the takeover or control of Russian banks by organized crime. According to a recent magazine article,[12] the Moscow city police estimate

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[11] Ibid. The banks are: Mosbusinessbank, Russian Credit Bank, Unicombank, Tokobank, Alfabank, Permkombank, Aviabank, Promradtechbank, the All-Russian Exchange Bank, Business Russia bank, Kristallbank, Ukrainian Privatbank, and the Byelorussian Belarus.

[12] Global Finance, January 1994.

that 25 percent of the Moscow commercial banks are controlled by organized crime. The Russian mafia allegedly uses bank records to obtain information about companies for extortion purposes. When banks refuse to allow intrusion by organized crime, dire consequences can result. According to a recent newspaper article,[13] Russian Interior Ministry statistics show that ten commercial bankers, including the chairman of one of the largest banks, Agropromstroybank, were killed by organized crime in 1993 and an additional four in the first half of 1994.

Finally, there are reports that money laundering by commercial banks in Russia, whether controlled by organized crime or not, is a serious problem. The CBR, working with the multilateral Financial Action Task Force (FATF), is introducing reporting and other requirements to combat illegal laundering of money.

Regulation and Supervision

The Central Bank of Russia has the sole jurisdiction over the regulation and supervision of banks and the banking system in Russia. It authorizes all banking activities, issues licenses, sets minimum capital standards and prudential liquidity ratios, specifies reporting requirements, inspects and supervises individual banks, establishes accounting standards for banks, and registers bank auditors. Three deputy chairmen of the CBR share responsibility for various aspects of the banking system: on-site inspections; off-site regulation and supervision; and regulation of the payments system. The CBR has local branch offices in each region that regulate the banks.

The basic legal foundation for the Central Bank's regulation and supervision of the Russian banking system is provided by the following: the December 2, 1990 law, *On Banks and Banking Activity*; the December 2, 1990 law, *On the Central Bank of the Russian Federal Socialist Republic,* which assigned the central bank the responsibility to supervise banking activity; and the April 30, 1991, regulation Instruction Number 1, *On the Procedures for Regulating the Acovines of Commercial Banks.*

Any bank operating in Russia must be licensed by the Central Bank. At least three founding members are required. No one shareholder can have more than 35 percent of the shares, although there is no test for ultimate ownership of juridical persons. This is the mechanism by which foreign banks can create subsidiaries — three affiliates of a foreign bank hold the shares of the subsidiary. Although the CBR scrutinizes bank officers, there are no established criteria to assess an individual's knowledge or skills.

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[13] Moscow Times, May 19, 1994.

Three categories of licenses are granted: a ruble-only license; an "extended" or limited license, which allows a bank to have up to six hard currency accounts with foreign banks outside Russia; and a universal or general license that allows a bank full banking operations, including foreign exchange trading. A bank must be in business usually at least a year before the CBR will grant it a general license. According to the CBR, there were 222 banks with general licenses and 723 banks with limited hard currency licenses as of October 1, 1994.

Under "Instruction Number 1" of April 1991, and additional instructions (including a regulation issued February 1, 1994), the CBR imposes a set of capital adequacy standards and liquidity measures that banks must meet. The ratios are weighted according to the risk of the asset. Banks also are subject to a minimum level of mandatory reserves at the central bank and a maximum amount of risk per borrower. However, capital adequacy requirements, including risk coefficients, are generally less demanding than in the West. For example, the CBR requires a capital-liability ratio of only 4 percent, implying an even-lower capital-asset ratio. Only a few Russian banks have met the capital standards of the Basle Committee on Banking Supervision (affiliated with the Bank for International Settlements). Loan loss provisioning has generally not occurred, as high inflation has contributed to the eventual repayment of the nominal debt. Provisions are not tax deductible. Finance Ministry tax regulations discourage the declaration of bad debts. According to some accounting experts, Russian banks do not have an incentive to declare a loan in default, since the lost principal is not deductible for tax purposes. Although, the CBR has recently recommended that bad debt should be tax-deductible, the State Tax Service has not yet approved this change. The debate is focused on the amount of deductions that should be allowed.

The Central Bank continues, however, to draft regulations providing for higher capital standards. On March 1, 1994, the CBR raised the minimum capital (authorized capital plus reserves) for newly licensed banks from Rbs 100 million to Rbs 2 billion (or ECU 1 million) to offset the erosion of the previous limits due to the effects of high inflation. Once a quarter, the CBR will announce a new limit to keep pace with inflation. Existing banks have until January 1995 to meet the new requirement. By January 1, 1999, all existing and newly licensed banks must raise their minimum capital to the ruble equivalent of ECU 5 million (or Rbs 10 billion), five times the current level. The only exceptions will be for agricultural cooperative banks (Rbs 100 millions) and banks that accept no deposits from the public (Rbs 500 million). As of October 1, 1994, according to the CBR, less than 300 commercial banks have a capital base of at least Rbs 2 billion and less than 50 banks have capital of at least Rbs 10 billion. The CBR expects that the many small banks will be unable to meet the new minimum capitals and will either have to merge or be acquired by larger banks.

Accounting

Accounting standards for Russian banks are inadequate compared to Western standards. In August 1993, the CBR issued Instruction Number 17, which requires Russian banks to move

from a cash-based to an accrual-based transitional accounting system. However, the new system will not be based on generally accepted accounting principles or on international standards of accounting, and in practice Russian banks have not yet adopted the new system. The CBR requires Russian banks to have external auditing, but the banks may use Russian auditing firms and Russian accounting standards. As of October 1994, approximately 50 Russian banks had been audited by one of the six major Western accounting firms. According to industry observers, the accounts had to be transformed to generally accepted accounting practices (GAAP) or international accounting standards (ISA) before the audit could take place. Another problem in auditing is the analysis of a credit portfolio, since Russian enterprises themselves have an inadequate accounting system. Russian banks are required to be examined on-site by central bank inspectors. In the first 10 months of 1994, inspectors examined 1,000 commercial banks according to the central bank. Russian banks are required to file quarterly reports and monthly updates with the central bank and to release an annual balance sheet to the public. According to industry observers, however, reporting requirements are not stringent enough, and the central bank could strengthen its use of the reports for surveillance purposes.

Deposit Insurance

There is currently no unified deposit insurance system per se. All household deposits at the Sberbank are automatically insured by the federal budget. From July 1991 until December 1993, the CBR maintained two funds for commercial banks, a Bank Insurance Fund and a Bankruptcy Fund. A bank was required to give 1 percent of its profits to each fund, until the sum of its contributions and reserves reached 25 percent of its authorized capital. In the event of a closure, both funds would have been transferred to a liquidation commission for use in claims by bank clients. Although the CBR has closed down Russian banks that have overdrawn their settlement accounts at the CBR, no Russian bank has yet gone bankrupt, and neither fund has been drawn upon. Beginning January 1, 1994, the Bank Insurance Fund was dissolved and the funds returned to the commercial banks. The Bankruptcy Fund still remains on the books of the Central Bank, but commercial banks are no longer contributing to it.

U.S. PRESENCE IN THE MARKET

The first presence of foreign banks in Russia took the form of joint-venture type operations with both Russian and foreign ownership. The International Moscow Bank (60 percent owned by five foreign firms from Germany, Austria, France, Italy, and Finland) was the first joint venture to establish in 1989. Dialog Bank (about 50 percent owned by foreign interests) was formed and began operating in 1989; it was the first with significant U.S. ownership. More recent examples include the Russian-American Investment Bank, the International Joint-Stock Bank, and the East-West Bank.[14]

The first foreign bank to establish an operating presence in Russia was the Bank of Austria, which started operations in early 1993 and has only a limited license. Later in the year, Credit Lyonnais of France and BNP/Dresdner (a subsidiary jointly owned by Banque Nationale de Paris and Dresdner Bank of Germany) opened full-service subsidiaries in St. Petersburg, and Bank of China opened a subsidiary in Moscow. On October 28, 1993, the Central Bank of Russia announced it was granting another six general licenses to foreign bank applicants. By the end of 1993, however, the first four banks were still the only completely foreign-owned banks operating in Russia.

On January 13, 1994, Citibank became the first U.S. bank to establish a subsidiary, reopening its office that was closed in 1918. Chase Manhattan, with a representative office in Moscow for 20 years, officially opened a subsidiary in September 1994. Bank of America, which has had a representative office in Moscow since 1974, fully staffed it in 1994, and Republic National Bank of New York opened its representative office in Moscow, also in 1994. Other U.S. banks are involved in Russia through offshore business, including Chemical Bank, Bank of New York, and New York Bancorp.

Wholly-owned U.S. and other foreign bank subsidiaries in Russia in their short operating life have tended to focus on specialized niches. The banks service their international clients and provide fee-based services such as consulting and cash management. They are involved in project financing and syndicated lending, using offshore resources. At least one foreign-owned bank is interested in serving as an "official dealer" in the government Treasury bill market and has received indications from the central bank that will be possible. To date, there has not been much corporate lending, and there is no interest in retail banking by foreign banks.

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[14] Financial and Business News, March 1994, #11.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks may enter the Russian banking market as a representative office, a participant in a joint venture bank, a minority holder in a Russian bank, or as a wholly-owned subsidiary. Russian banking law does not provide for entry via a foreign branch. However, a two-year moratorium restricts foreign banks to serving nonresidents only; this restriction applies to newly licensed subsidiaries, as well as already licensed subsidiaries that had not started serving residents as of November 15, 1993.

The prevailing attitude among many Russian commercial bankers toward foreign banks is one of suspicion and antipathy. The infant industry argument is usually cited as the main reason to restrict the entry of foreign banks. According to this line of reasoning, the Russian banking system is only five years old and no other country with such a new banking market allows unrestricted foreign bank entry; Russian banks are incapable of competing with the capital, know-how, and technology of foreign banks. Russian banks also have expressed fears that foreign banks will hire away employees with higher salaries, compete away their clients, and only take deposits and not make loans to Russian businesses. In spite of this, the central bank has been in the forefront of encouraging foreign banks in Russia, arguing that foreign banks will offer new services, new international links, employee training, new technology, and more competition to reduce the fees and large interest rate spreads characteristic of the domestic system.

The central bank made rapid progress in supporting foreign bank entry in 1993. By October, it had granted full operating licenses to 12 foreign-owned banks. However, in November 1993, President Yeltsin issued a decree imposing a two-year moratorium on the new entry of full-service foreign banks.[15] Foreign banks and joint venture banks with more than 50 percent foreign ownership that had not begun servicing residents of the Russian Federation by November 15, 1993, would not be permitted to deal with residents (including Russian subsidiaries of foreign-owned companies), until January 1, 1996. Initial interpretation was somewhat unclear, especially in terms of overruling the central bank regulation. At the time of the decree, only four out of the ten foreign banks had established and opened their subsidiaries. However, other banks had "provided services" to Russian clients and, on that basis, some decided to proceed with their business plans.

In December 1993, President Yeltsin reached an agreement with the European Union on a trade pact, which reportedly included a commitment by him to lift the moratorium on the European banks affected within six months. In March 1994, Prime Minister Chernomyrdin also stated publicly that the government would review the decree with a view toward eliminating the foreign

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[15] Edict No. 1924, dated November 17, 1993, *On the Activities of Foreign Banks and Joint Banks involving the Funds of Nonresidents on the Territory of the Russian Federation.*

bank restrictions. Other officials in the Russian government were discussing the removal of the foreign bank ban as well.[16]

On June 10, 1994, President Yeltsin signed a decree, which had the effect of lifting the moratorium only for European banks already licensed. The decree implemented the president's agreement with the European Union by permitting foreign banks from those countries with which Russia had in force a bilateral investment treaty to deal with Russian residents. Since the Russian Parliament has not yet ratified the bilateral investment treaty with the United States, U.S. based banks that had not already been dealing with Russian residents by November 1993, may not do so until January 1996, or when the investment treaty takes effect, whichever comes first. In September 1994, President Yeltsin introduced the treaty with the United States into the Duma. At the same time, however, the Duma is considering a new commercial banking bill, which would reimpose the moratorium for all banks under the conditions outlined in the November 1993 decree.

There are two other examples of differential regulations for foreign-owned banks, which, however, are currently not limiting. First, an April 1993 regulation issued by the CBR limits the aggregate capital of all foreign-owned banks (banks with more than 50 percent foreign equity) to 12 percent of the aggregate capital of the Russian banking system. As of January 1, 1994, however, foreign banks' capital was 7 percent according to a deputy chairman of the CBR. Second, the minimum capital required to establish foreign-owned subsidiaries is higher than that required for domestic banks, $5.7 million versus $1.6 million (Rbs 2 billion). However, this has not been a problem for foreign banks.

As mentioned at the outset, another central bank regulation, while not explicitly discriminatory against foreign banks, has the effect of making it more difficult for newly established foreign banks to attract clients. Under Russian banking law, enterprises are restricted to only one ruble bank account anywhere. Thus, companies may not open additional accounts with a foreign bank unless they close their existing account with their "house" domestic bank. The existing bank must give its permission to close the account, which can make it difficult for foreign banks to attract new clients. Since many foreign banks also only want to offer specialized services, this regulation serves as a barrier to expanded business.

[16] Interfax news service, April 20, 1994.

FINANCIAL MARKET DISCUSSIONS

Although there are no formal financial market discussions per se, U.S. administration officials and members of Congress have raised their concerns with the moratorium on foreign bank operations with the Russian authorities.

More generally, considerable work is being done in the West to improve the Russian banking system. The United States, both bilaterally and multilaterally through the international financial institutions, is providing technical assistance to Russian bankers and the central bank. The Russian-American Bankers Forum (affiliated with the Financial Services Volunteer Corp) in 1992 successfully trained several hundred Russian commercial bankers in the United States, and the U.S. Agency for International Development continues to provide training for commercial and central bankers.

The World Bank and the European Bank for Reconstruction and Development (EBRD) have embarked on a $300 million program (the "Financial Institutions Development Project") to improve the Russian banking system. Starting with the 50 largest banks in Russia, 21 banks were pre-screened to become what will be known as "International Standards Banks (ISB)." In return for agreeing to improve capital adequacy, the ISB banks will be eligible for loans and technical assistance, including "twinning" arrangements with western banks. The project will also include the training of central bank inspectors and assistance to help Russia to move to international accounting standards.

Nevertheless, much still needs to be done to completely transform Russian banking to a market system based on prudential concerns, the protection of household deposits, and safety and soundness. Technical assistance can focus on programs designed to improve the payments system, capital adequacy standards, bank inspection and supervision, accounting and auditing standards, reporting requirements, and the deposit insurance scheme.

RUSSIA

SECURITIES

SUMMARY

The securities market in Russia is technically only four years old, but for all practical purposes was created almost overnight only two years ago by the mass privatization program. It is a dynamic market that is evolving extremely rapidly and where new developments occur almost daily. The market lacks a solid legal foundation, and Russian authorities are still developing the policy direction in which they want the industry to go. In the absence of a strict regulatory regime, private sector market participants have relentlessly pursued business opportunities and developed new securities products and trading practices.

The finance ministry, central bank, and the privatization ministry serve as the main regulatory bodies, sitting with other agencies on a securities commission that serves as a coordinating group. A December 1991 regulation serves in lieu of a basic securities law. The absence of effective legislation and regulations, the lack of information and public disclosure, and abusive market practices negatively affect the market's integrity and undermine the public's confidence. However, legislation is currently being drafted to address such issues as standards of conduct, issuing requirements, trading practices, shareholders' rights, and regulatory and supervisory responsibilities. There is a high degree of consensus among market participants and policy-makers to establish a quality securities regulatory framework on as short a timeframe as possible.

Russia's mass privatization program, begun in October 1992, has served as the largest source of equity shares. Almost 150 million privatization vouchers were issued, one each to every Russian citizen. The voucher could be exchanged for shares in privatizing companies, sold for cash on commodity exchanges or elsewhere, or traded for shares in voucher investment funds similar to mutual funds. Russian brokerage firms have taken advantage of the sudden creation of millions of shareholders by actively buying and selling equities, almost always over-the-counter, rather than on a stock exchange. Entry and establishment in the market is open to foreign-owned securities firms. A U.S. firm is currently fully licensed by the Finance Ministry as a domestic broker-dealer, and other firms are beginning to trade in the market.

The domestic government debt market, although less than two years old, has been successful due to good development, organization, and supervision. The market consists primarily of three- and six-month discounted Treasury bills, sold at an auction to a syndicate of official dealers. The size of the issues grew a hundredfold in the first year, and issues have almost always been oversubscribed. Although no wholly-owned foreign firm is a member of the official dealer syndicate, two joint venture firms are, and the criteria appear to allow the possibility of foreign firms to join in the future. A dollar-denominated domestic government debt market also exists with increasingly active foreign participation.

DESCRIPTION OF THE MARKET

Although an emerging market, the Russian securities industry already possesses many of the same types of diverse market participants found in a Western securities market: broker-dealers, stock, commodity, and currency exchanges; commercial banks; depositories; and venture capital funds. Not found in a Western market are the voucher funds, public sector-sponsored investment funds, and various types of hybrid organizations. The official regulatory bodies include the central bank, the finance ministry, the privatization ministry, the anti-monopoly committee, and a securities commission.

The securities instruments found in the Russian market, however, are much more limited in number and variety, although the industry is rapidly developing breadth in the transition to a market economy. Among the various instruments are: privatization vouchers (which have since expired); corporate shares; federal government Treasury bills; municipal bonds; bearer securities; futures contracts; futures contracts on currencies and commodities; corporate debt; debt-equity hybrids; promissory notes; gold certificates; U.S. dollar bonds and securitized loans issued by the Bank for Foreign Economic Relations; and various types of hybrid instruments that blur the distinction among securities, money market, and commodity instruments. Several brokerage firms are also experimenting with derivatives instruments, but their use remains very limited.

Many observers have characterized the Russian market as disorganized, chaotic, unregulated, and terribly fascinating, stimulating, and highly profitable. The industry is evolving so rapidly — sometimes on a weekly or even daily basis — that it is difficult to keep up with all the changes. Written information and materials more than six months old are often out of date.

Information on the size of the market is difficult to obtain. One estimate of the initial capitalization of privatized state-owned enterprises is $6 billion, based on the total value of privatization vouchers issued for all enterprises by mid-1994. As this makes the market in Russia, a country of 150 million people, the same size as that in Poland or the Czech Republic, most market players consider it grossly undervalued. By comparison, the markets in Hong Kong and Mexico are capitalized at $300 billion and $145 billion, respectively.[17] However, share prices in Russia are rapidly increasing. As of October 1, 1994, the market valuation of 30 companies that comprise the new stock market index published by *The Moscow Times* reached $27 billion.

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[17] *Russia: The Ultimate Emerging Market*, Forbes, February 14, 1994

Brief History

The securities market in Russia is technically four years old. For all practical purposes, however, the market is only two years old and began with the mass privatization voucher program. The market's theoretical start can be traced to the establishment of the first public joint-stock company, the Kamaz truck company, in 1990. The first exchanges also appeared in 1990, but at first tended to trade only raw materials and other commodities.[18]. The first securities-only exchange, the Russian Central Stock Exchange, was founded in November 1990, and the Leningrad (later St. Petersburg) Stock Exchange was formed in February 1991. By the end of 1991, well over 100 exchanges had opened, concentrated in the Moscow, St. Petersburg, the Far East, and the Urals. A shortage of securities resulted in a large decline in exchange trading by the end of 1992.[19] However, an informal over-the-counter market (OTC) developed, and most trading moved off-exchange.

The domestic government securities market itself only recently celebrated its one-year anniversary. In May 1993, the government issued its first security, a three-month Treasury bill on the Moscow Interbank Currency Exchange (MICEX). By July 1994, the market had enjoyed 15 successful auctions. Six-month T-bills have been issued, other maturities are being considered, and MICEX is preparing for trading in T-bill futures.

Primary Markets

Privatization and Post-Privatization. The privatization voucher has been the most liquid and perhaps most successful of any Russian security. President Yeltsin set the stage for privatization with his decree of November 25, 1991, which provided the legal basis for transfer of ownership. The first small-scale enterprises (less than 200 employees and Rbs 1 million in assets) were privatized in early 1992. By the end of 1993, 70 percent of the approximately 125,000 small enterprises had been privatized.

The mass privatization program to privatize medium- and large-scale enterprises was initiated in 1992. Between October 1992 and January 1993, the Government of Russia issued a privatization voucher with a nominal value of Rbs 10,000 to each of the approximately 150 million Russian citizens. Under the program, a person had the right to use the voucher to bid for shares in an enterprise being privatized in an auction; exchange the voucher for shares in a voucher investment fund (similar to a mutual fund in the United States), which in turn used the vouchers to bid for enterprise shares; or sell the voucher for cash, literally on the street, or on

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[18] *Guide to World Equity Markets (1994),* "Securities Markets in Russia", Euromoney Publications, unpublished draft.

[19] *Russia, The Banking System in Transition*, Annex: Russia's Securities Markets, World Bank, September 14, 1993.

one of the commodity exchanges trading vouchers. By June 30, 1994, about 144 million vouchers (out of 148 million) had been used, half to purchase enterprise shares directly and the other half held in voucher investment funds, numbering roughly 650. By some accounts, 40 million Russian citizens are now *direct* shareholders in companies, more than in the United States, both on absolute terms and as a share of the population.

The first auctions of medium- and large-sized enterprises took place in December 1992. The State Committee for the Management of State Property (GKI), responsible for privatization, established three options for privatizing companies. Under the various options, management and employees could acquire between 40 percent and 51 percent of the shares at favorable rates and bid with the public for the remaining shares. Specifically, under the first option, employees received an initial 25 percent of the equity in preferred stock for free and another 10 percent in common stock for 70 percent of the nominal price; management received 5 percent of the equity in common stock at nominal price, which resulted in a total of 40 percent of equity to management and employees. Under the second option, the most popular variant, management and employees received 61 percent of the equity in common stock for 1.7 times the nominal price. Under the third option, the least popular, a group of managers and employees of a small company that fulfilled an approved business plan within a year would receive 20 percent of the equity in common stock at the nominal price and an additional 20 percent at 70 percent of the nominal price.

After one of these three options were effected, the remaining company's shares went to public auction. At least 29 percent of the shares had to be auctioned for vouchers, and the government retained a portion of the shares for sale in the post-privatization period. By June 1994, at least 11,000 (or 75 percent) of the 14,500 medium- and large-scale enterprises had been privatized. The use of the privatization vouchers accounted for the bulk of primary issuance of corporate paper, and according to press reports, voucher trading accounted for 99 percent of on-exchange secondary market trading in Moscow. The situation changed on July 1, 1994, when the mass privatization program began winding down, but details are not yet readily available.

Non-Government Issues. Excluding shares issued in exchange for privatization vouchers, equities issued by banks are the largest category of primary issues, although this has changed since the effective end of the mass privatization program on July 1, 1994. Detailed data are not yet available, but Russian authorities believe that, as of October 1994, about half of all privatized companies have expressed an interest in raising capital through another round of public offerings beyond the initial distribution of shares under the privatization program. Several companies are expected to bring issues to market in the fall 1994, but are facing regulatory and infrastructure challenges.

The securities market participants in Russia are extremely creative, and hybrid instruments unthought of in the West are springing up. For example, companies might offer an instrument that combines a bond, a warrant, and a lottery ticket for cash winnings. Other companies issue

what is sometimes referred to as a "zero-interest redemption right," which a purchaser may use to exchange for corporate debt, equity, or a lottery participation to obtain free or discounted consumer products, even including new automobiles. However, the "right" might stipulate arrangements that might not be acceptable in the West, such as giving up the voting rights attached to an equity common share.

Recently, bearer securities (or depository receipts) have become a popular financing vehicle for new "venture" companies. Voucher investment funds and other financing companies, through special purpose subsidiaries, have issued bearer certificates to avoid registration costs, lengthy registration procedures, and transaction taxes. These unregistered certificates trade freely on some exchanges and in the streets and carry no voting or other shareholder rights. Some represent no claim whatsoever on the company issuing them and the use of the proceeds derived therefrom are not used to finance productive capacity. The bearer certificates are susceptible to fraud and counterfeiting, and many companies, such as the joint-stock company "MMM," self-quoted the prices of their shares and relied on pyramid or Ponzi schemes to attract more buyers in order to pay dividends to existing investors.

Other instruments, closer in nature to money market instruments than securities, include promissory notes issued by banks with maturities of 30 days to 3 months and promissory notes issued by nonbanks, similar to commercial paper, with maturities of seven days. Although the issues may be denominated in rubles, dividend cash flows in hard currency are possible. A fixed income instrument is popular because it avoids placing the onus on an unsophisticated public of trying to determine the various risks of an equity and avoids the tax consequences caused by the double taxation of dividends. In general, though, the highly inflationary environment creates disincentives for financial instruments. The monthly inflation rates of 20 percent that were common in 1993 required compound annual interest rates of almost 800 percent to break even. Rates of 10 percent per month in the first part of 1994 still required over a 200 percent compound annual rate, which can be difficult to match.[20]

Government Debt

Most newly issued government securities take the form of discounted Treasury bills, with either a maturity of three months, or, to a lesser extent, six months. The Finance Ministry issues the debt on behalf of the Russian government, and the Central Bank of Russia (CBR) acts as fiscal agent. The first T-bills were issued in May 1993 and, since then, there has been one issue per month each third Tuesday. In September 1994, the government increased the frequency of 3-month T-bills to twice a month and 5-month T-bills to monthly. With only a few exceptions, mostly during periods of political uncertainty, the issues have been oversubscribed and very successful. The auction and the redemption at maturity have gone smoothly. Market observers

[20] Interest rates in Russia are generally quoted at simple annual rates, but are payable monthly. Thus, a loan quoted at 120% requires payment of 10% per month, which is equivalent to a compound annual rate of 214%.

have praised the entire creation, development, and implementation of the government securities market. The first issue totalled Rbs 1 billion and, by the time of the tenth auction less than one year later, had reached Rbs 100 billion. The government's goal in recent issues has been to double the size of each issue. The CBR hopes that the December 1994 auction will amount to about Rbs 2 trillion, which would bring the gross total issued for 1994 to around Rbs 7 to 8 trillion, or Rbs 2 to 3 trillion net of redemption. Future plans call for one- year coupon bonds to be issued quarterly beginning in the fall 1994.

The T-bill issues are sold at an American-style auction (bills are sold at the bid price until the cutoff price). The issue is sold via a syndicate of "official dealers," similar in concept to primary dealers in the United States. Noncompetitive bids, up to a 20 percent limit of the issue, are permitted and sold at the average weighted price of accepted bids. The initial group of official dealers, consisting of 21 banks and 3 brokerage firms (one of which was suspended several months later), was chosen in March and April of 1993;[21] in October 1993, the group was enlarged to 29 dealers. In April 1994, the number was further expanded to 55 dealers, of which 53 are banks and 2 are brokerage firms. Two of the banks are joint-venture banks, the International Moscow Bank and the Dialog Bank (which has partial U.S. ownership).

The auction takes place on screen-based terminals in a trading room at the Moscow Interbank Currency Exchange (MICEX), a currency exchange organized by the central bank in 1991. MICEX started with 26 member-owner Russian commercial banks, expanded to 65 member banks and financial institutions by the end-1993, and currently has 169 members. The number of official dealers is limited to the physical amount of space.

Although the exchange has been able to enlarge the trading room over time. The CBR expects another increase in the number of official dealers later in 1994. There are no specific written guidelines or a "formula" to become an official dealer, but the criteria are considered to be widely known in the market. The CBR requires a written application, and the Bank Supervision Department considers the volume of assets, capital, profits, current holdings of government securities, capital adequacy ratios, and good corporate behavior of the applicant. Before the applicant is approved, the application is also reviewed by the Finance Ministry and MICEX. Nationality of the owner of the applicant is not a factor, though the applicant itself must be a Russian legal entity.

The CBR, Ministry of Finance, and MICEX have discussed plans for further expansion of the market to other regions in Russia over the next year. One plan calls for establishing the market at five other regional currency exchanges: St. Petersburg, Yekaterinburg, Novosibirsk, Rostov-on-Don, and Vladivostok. The system would handle both primary issue and secondary trading. The trading system would be electronically linked and thus integrated and uniform, with one

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[21] *Outlook for Warrantless Government Bond Market*, Central Bank of Russia, unpublished report, undated (probably August 1993).

depository and clearing mechanism. The payments mechanism, however, is still an unresolved problem.

In addition to Treasury bills, the government issued in the fall 1993 "gold certificates." The certificates function as futures securities, representing a claim on a total of 100 tons of gold, redeemable in kind in one year. In April 1994, the government also issued Rbs 500 billion in promissory notes representing the government's outstanding debt of unpaid 1993 budgetary subsidies to industry. The government expects to issue a total of Rbs 1.1 trillion by the end-1994.

In October 1993, the Ministry of Finance issued hard currency bonds against the outstanding liabilities of the state-owned Vnesheconombank (VEB or Bank for Foreign Economic Relations). Russian foreign trading companies and foreign joint ventures had hard currency assets of $7.89 billion on deposit at VEB, which were frozen upon VEB's bankruptcy in December 1991. By the spring of 1994, bonds had been issued for about 60 percent of the accounts, according to press reports. The bonds are of various denominations ranging from $1,000 to $100,000 and maturities of 1 to 15 years. The first tranche of $500 million matured on May 14, 1994, and was fully redeemed.

Secondary Markets

With few exceptions, the secondary markets in Russian securities are still thin and illiquid. Privatization vouchers (during voucher privatization), government T-bills, and VEB debt enjoy frequent trading and large volumes. However, most VEB debt trading occurs offshore in London and in New York, although since March 1994, trading also takes place biweekly on the MICEX, and several banks and brokers also trade in the debt off-exchange. But, for the most part, trading in corporate debt and equity is thin and occurs mostly off the exchanges. In addition, the domestic secondary market is characterized by a predominance of large strategic investors, both domestic and foreign, rather than small individual investors as the purchasers of equities. Although 30 to 40 million Russians are shareholders, they have been selling, rather than buying, equities. To the extent that there has been any purchasing at the retail level, it has been in speculative bearer instruments.

Russian Stock, Commodity, and Currency Exchanges. There were 120 stock exchanges and stock-trading departments of other types of exchanges licensed and regulated by the Finance Ministry in 1993, but, during the course of the year, the ministry shut down 80 of them due to legal infractions. As of February 1, 1994, there were 60 licensed stock exchanges. Two types of stock exchanges exist, a classical exchange with floor trading only by the member-shareholders of the exchange who are licensed professionals, and a "nonclassical" exchange with floor trading by brokers and more lax trading and issuing rules. At the latter, it is also frequently possible for anyone to purchase a nominally priced ticket and gain entry to the trading

floor. After the effective end of vouchers on July 1, 1994, most of Russia's exchanges became reliant on high volumes of trading in bearer securities for the bulk of their business.

At end-1993, there were also 177 licensed commodity exchanges in Russia, according to the Anti-Monopoly Commission, which regulates them. But many of these exchanges have either suspended trading or are planning to convert to stock exchanges. On other exchanges, commodity trading is only a small proportion of total trading. The Russian Commodities and Raw Materials Exchange was the largest voucher trading exchange in Russia, and the Moscow Commodities Exchange is the largest dollar futures exchange.

Currency exchanges in Russia also trade securities, and MICEX is one of the key securities exchanges in Russia. It has exclusive jurisdiction over the trading of government T-bills. Trading can only be done by the official dealers; the government enforces such trading through its book entry system. Nondealers must purchase T-bills through the official dealers. Individuals, who only gained the right to purchase T-bills in October 1993, must also make purchases through the official dealers. In June 1994, trading frequency on the MICEX increased from three times per week to daily. Over the next year, the secondary market in government debt will be expanded to four other regions. MICEX is also working on a new system that will allow it to initiate a futures market in T-bills for trading by certain certified official dealers. Finally, MICEX plans to start trading equities in the future after linking electronically to the four other regions.

Over-the-Counter Market: The off-exchange markets in Russia represent a critical component of the securities market. Regulators estimate that as much as 80-85percent of all trading is over-the-counter (OTC); traders and market participants estimate an even higher 95percent-99percent. A number of financial information companies have launched services to monitor OTC trade volumes and prices of selected companies. In September 1994, *The Moscow Times* began publishing the first public stock market index, covering 30 leading Russian companies, and based on daily surveys of prices among major Russian brokers.

However, the Russian OTC market is unorganized, unsupervised, and nontransparent, although individual market participants are increasingly sophisticated players. Very little information is available on the market, though some analysts estimate monthly trading at as much as $500 million, and liquidity and turnover are increasing. The OTC market has very little in common with the NASDAQ in the United States. The Russian market is not electronic; broker-dealers trade mostly by phone and (almost literally) on the street. Russian brokers often purchase shares directly from employee shareholders at plant gates by using roadside stands and wooden placards. Plant gate trading has apparently been successful in some regions as employees either trade shares in their own companies for shares in other companies that pay higher dividends or sell their shares to increase their cash flow in cases where wages have been frozen or are in arrears. In some cases, companies have been known to force trading by freezing wages in the hopes of owners or managers picking up additional shares in their own companies.

Some market participants have made an attempt to organize a "pink sheet" type of price information sheet, but these sheets are generally considered to be more of an advertisement than a market. Prices listed are indicative only and users must be prepared to negotiate. There is little tradition of oral contracts (sometimes even of written), so that prices quoted over the telephone are not necessarily valid at the time of the actual transaction. Therefore, traders must arrange for immediate cash payment and physical settlement of the transaction, especially while domestic electronic payments and settlements of transactions continue to prove unsatisfactory. The result of this stage of market development, especially given the predominance of transactions between Russian brokers and foreign institutions, has been electronic offshore, dollar settlement.

Given the paucity of market regulations, banks and voucher investment funds can operate as market-makers in their own shares and engage in self-quoting of share prices. There have been allegations of some manipulation of share prices off-exchange in order to influence the on-exchange prices, which are more often quoted in the press as advertisements.

Securities Regulation and Supervision

Regulators. The regulation and supervision of Russia's securities market lacks a solid legal foundation and is still rapidly evolving. There is no set of securities laws per se, only decrees and regulations that have been issued and procedures dictated by the regulatory authorities. A wide range of legislation, however, is in draft.

There are three primary regulators in the Russian securities market: the Finance Ministry, the Central Bank of Russia (CBR), and the State Committee for the Management of State Property (commonly known by its Russian abbreviation, GKI). In addition, there is a coordinating body, the Russian Federal Commission on Securities and Stock Exchanges (RFCSSE, but also known informally as the Russian Securities and Exchange Commission, or RSEC). Other lessor regulators include the State Committee for Anti-Monopoly Policy, and the Support of New Economic Structures (Anti-Monopoly Committee), which regulates commodity exchanges, the overseas affiliates of Russian securities firms, and anti-trust activities; the State Tax Service; and the Ministry for Social Protection, which regulates pension funds.

Since the process of privatization — i.e., the auctioning of enterprise shares to employees, managers, and the public, can be considered the primary issuance of shares — the GKI retains responsibility for the initial issue and registration of equity shares by newly privatized enterprises (though not for subsequent issues). The GKI also licenses and regulates the voucher investment funds. The CBR regulates commercial banks in their capacity as securities market participants and registers the primary issuance of bank shares. The CBR also acts as fiscal agent for the Finance Ministry in the primary issuance of government securities and oversees the secondary market trading in such securities.

The bulk of securities market regulation, however, falls to the Finance Ministry, which considers itself to have had a role similar to that of the U.S. Securities and Exchange Commission (SEC). The Finance Ministry establishes the basic "rules of the game" for all securities market participants and instruments. It registers and sets the requirements for issuers and issues (other than those under the jurisdiction of the CBR or the GKI); approves prospectuses for securities issued by joint-venture or Russian-owned firms, including voucher and other investment funds; licenses and supervises brokerage firms; licenses and supervises stock exchanges and the stock departments of those commodity and currency exchanges that trade securities; establishes conditions and rules for the secondary market trading of securities; licenses and sets rules for investment companies and investment funds; and, trains specialists in the field through the Academy of Finance and certifies them.

Most issuers and market participants register through the regional offices of the Finance Ministry. However, those issuers with more than Rbs 50 billion in start-up capital or with foreign participation must register with the main Ministry of Finance office in Moscow.

In March 1993, President Yeltsin established, by decree, the Russian Federal Commission on Securities and Stock Exchanges (RFCSSE) to coordinate government efforts in the securities market. The commission consists of nine persons, representing the following government bodies: the legal department of the Presidential Administration (GPU); Ministry of Finance (three representatives); the GKI (two representatives); the CBR; the Anti-Monopoly Committee; and the State Property Fund.[22] The representatives from GPU and GKI serve as the chairman and deputy chairman, respectively. There is no formal staff, though plans are being developed for a secretariat. The RFCSSE is mandated to meet monthly to discuss the development of the securities market in Russia; draft legislation on the issuance and trading of securities; coordinate the establishment of requirements on market participants; and release information to the public on the market. The RFCSSE and other agencies are currently drafting a basic law on the securities market, which will include broader definitions of securities and trading activities; standards of conduct; rules on licensing; regulation and self-regulation, supervision, and enforcement; rules on registries, depositories, clearing and settlements; issuing requirements and disclosure rules; and shareholder's rights. Parliamentary hearings on this draft and others may occur in the fall 1994. The Duma is already working on a new civil code, which will incorporate the commercial law that serves as the foundation for a specific securities law. The Anti-Monopoly Committee has also proposed legislation to counter fraud and false advertising, implementing a decree issued by the president in June 1994.

Regulation. There is no set of securities laws or codes *per se* governing the Russian securities industry, only a series of regulations and rulings. USSR Regulation 590 was issued in June 1990, specifying requirements on the establishment of joint-stock companies. It was superseded

[22] Instruction No. 163 issued by President Yeltsin, dated March 9, 1993, informal English translation.

by Regulation 601 of the Russian Federation in December 1991, when the USSR was dissolved. Regulation Number 78, issued by the Russian Federation on December 28, 1991, provides the basic regulation for the securities industry.

Voucher funds are regulated by two decrees: the Presidential Decree of October 7, 1992, *On Measures to Organize a Securities Market in the Process of Privatization of State and Municipally Owned Enterprises*; and Presidential Decree Number 1238 of August 10, 1993, *On Protecting the Rights of Citizens of the Russian Federation to Take Part in Privatization.*

There is no system of self-regulation in Russia, although the government and GKI, in particular, are encouraging trade associations to form the basis of future self-regulatory organizations (SROs) and the government's draft securities law will provide the legal foundation for SROs. The Moscow-based Professional Association of Securities Market Participants, the Siberian Association of Securities Dealers, and similar associations in three other regions are preparing to become future SROs for brokers. The Union of Stock Exchanges could become an SRO for stock exchanges. For the voucher investment funds (VIFs), the Russian VIF association (SKIF) and the VIF Support Legion are the major organizations. Finally, the Association of Non-Government Pension Funds is a possibility as a future SRO, if circumstances warrant.

Issuing and Registration Requirements

Private companies wishing to make a public offering must register each issue with the Ministry of Finance. The Moscow office puts out guidelines to the local branches of the Finance Ministry, which oversee the actual control of issuers and the results of issuances. Prospectus requirements, however, are substantially weaker than in the United States and exclude, for example, an adequate discussion of market and credit risks. Prospectuses and other relevant information are not handed out, only kept on file, but customers usually do not seem to object. Western firms, however, have said that a major hurdle to additional investment is the lack of public assess to prospectuses and lack of information about companies.

A November 1993 presidential decree disallows bearer instruments and requires all purchasers of an issue to register their share acquisitions. However, a legal loophole in the decree has been exploited so that bearer instruments are now common. To exploit the loophole, the original purchaser (usually a broker) becomes the nominal custodian to whom the instrument is registered with the registrar. When the broker resells the securities, the new customer receives only a receipt, which in turn can be traded; no new registration is required with the Ministry of Finance. The broker usually retains no record of the bearer instrument transaction because of tax considerations, a lack of "know your customer" concern, and a lack of interest in developing customer relationships.

For regular registered shares, a broker on behalf of a client will reregister a share with a company's registrar. For newly privatized enterprises, the shares are dematerialized and are

recorded in a shareholder registry, which is usually paper-based, though computer entries are possible. Ownership transfer is effected upon the appropriate change in the registry, and an extract of proof of transfer is issued to the broker. Most companies maintain their own shareholder registries at the plant site, rather than trading location, making the physical transfer costly. Under the June 1994 presidential decree (Number 1769) on shareholder rights, companies with more than 1,000 shareholders must have a third-party registrar, which usually results in a commercial bank or brokerage firm. Market participants have expressed concern with the lack of regulatory oversight over the registrars and of legal recourse in the event of problems with the registry. Some companies have been known to circumvent the decree by setting up dummy subsidiaries to serve as registrars. In other cases, a conflict of interest arises regarding brokerage firms serving as registrars that have access to client lists of other brokers. Resolution of these and other problems are a prerequisite for the ability under U.S. law of U.S. mutual funds investing in Russia.

The Depository Clearing Corporation (DCC) in Moscow, a member organization of 12 brokers and 1 financial company, was organized to provide registry services and securities clearing and settlement for financial institutions trading in Russia. It will represent its clients in registering securities at individual registrars, eventually serving as the nominee shareholder in the registry. It also plans to clear and settle securities transactions for its members, maintain the physical securities certificates in a depository and dematerialize them. Other services to be provided eventually include collection of dividends and interest and the exercise of rights on behalf of clients. The role of shareholder registries, securities clearance and settlement, and the issue of custodial services, all matters taken for granted in a western market, are key to the further development of the Russian securities market.

Licensing and Reporting Requirements. Market participants themselves must be registered, usually with the Finance Ministry. Nationality is not a factor. Individuals must take knowledge-based exams on the tax system, accounting principles, and the securities markets. Only a small proportion of applicants pass the exams and must then undergo background checks. A legal entity, which includes a stock exchange, brokerage firm, investment fund, and consulting company, must supply articles of incorporation or its charter. The registrant can only trade in securities and cannot engage in nonfinancial business. A specific amount of startup capital is required. The registrant firm needs to have qualified persons for the positions of president, vice president, accountant, and the head of the trading department. Exchanges must have Rbs 2 billion a month in turnover to retain their registration. Annual and monthly reports are required.

Nevertheless, many market participants consider the process to be a simple registration, with minimal oversight and few reporting requirements and followup contacts. Western traders bemoan the lack of a standard of conduct and complain that the GKI, Ministry of Finance, and CBR infighting leads to the issuance of contradictory rulings. This makes it difficult for market participants to comply with all the regulations and contributes to a culture of breaking the rules in order to survive.

Regulatory Challenges

The basic theoretical underpinnings of the securities market are still under heated debate in Russia. Neither the regulatory authorities nor the market players have reached a complete consensus on the policy direction for the industry. Some observers have characterized the current industry as akin to that in France where all types of firms can compete in the securities market. The Central Bank of Russia is in favor of a German type model for the industry, where universal commercial banks, as the dominant organizational type, engage directly in the securities business. The CBR argues that banks have more capital, are better regulated, and the model will allow consumers one-stop shopping. The GKI, on the other hand, favors the Anglo-Saxon model of separate securities firms and a restriction on the ability of banks to act as agents in the securities business. The GKI has several concerns with the role of banks in the securities market. These concerns include banks' general inclination at present to promote short-term credits to enterprises rather than equity finance and potential conflicts of interest, both in terms of owning shares in commercial companies, as well as in brokering the equity shares of companies that are also bank clients. The Duma is expected to take up the issue in the fall 1994 when it considers the various drafts of the new securities law.

The development and the regulation of the OTC market is another regulatory challenge facing Russia. Given the geographic size of Russia with 11 time zones, policy officials believe that an NASDAQ-type electronic system is needed to connect the far regions of Russia. Initial plans are being made for interdealer trading systems in five regions that will be eventually linked. As part of this process, Russia will also need an adequate system for the monetary payment of securities and a clearing and settlements system for securities themselves.

The GKI is currently making a major policy push to develop a self-regulatory organization (SRO) system in Russia, a plan it says is supported by all the major private and official securities market players in Russia, except for the Moscow stock exchanges. The system that will develop will likely be a regional SRO network, rather than a nationwide SRO system. Many policy officials believe that a strong U.S.-type central securities and exchange commission is not a workable plan in Russia at the moment given the geography and the diverse type and number of market participants. Thus, they view it as more effective to place the burden of regulation on the market itself by giving more influence to SROs than in the United States. Officials still believe that an overall coordinating body such as the RFCSSE is needed to iron out disagreements and that it will be essential eventually to have one central regulatory body (in October 1994, President Yeltsin was considering issuing a decree to this effect). The draft securities law will include basic provisions to implement an SRO system.

Market integrity is a major policy problem in Russia. The market suffers from a lack of information and public disclosure. The existing laws are inadequate, especially in the enforcement area, against such practices as conflicts of interest, insider trading, front running, self-quotation of share prices and price manipulation, fraud, and false advertising. Stories are

prevalent in the press of examples of brokers buying ahead of customers, manipulating stock exchange and off-exchange prices, falsifying sales, etc.[23] One voucher investment fund disappeared in 1993, forcing the GKI to reimburse shareholders with additional vouchers since no securities investment protection fund exists in Russia. False advertising is also prevalent in the public media, periodicals, and billboards. During 1994, some firms advertised 2,000-3,000 percent dividends per year. A pyramid scheme run by the joint stock company MMM, an affiliate of the voucher investment fund MMM Invest, collapsed in the summer 1994, prompting calls for tighter regulations. In June 1994 President Yeltsin issued two decrees addressing shareholders' rights and truth-in-advertising. However, as of October 1994, the former decree had not yet been fully implemented.

Russian authorities face other regulatory challenges over the next year or two. Problems include the transparency of market regulations; transparency of market practices; investor protection; shareholder rights; compliance and enforcement of infractions; protection of minority ownership rights; public disclosure for issuers, market participants, and the market itself; accounting standards; registration and transfer of corporate equities including oversight over registrar activities; and investor education.

Finally, tax policy problems are of regulatory interest. A 0.3 percent tax on each side of a trade, capital gains taxes paid by the seller, and taxes on revenues instead of profits could affect the liquidity of the market in the future.

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[23] *Russia: The Ultimate Emerging Market*, Forbes, February 14, 1994

U.S. PRESENCE IN THE MARKET

Most U.S. and foreign-owned financial institutions have an involvement in the Russia securities market from offshore, either in New York or London, trading external debt or providing project financing. Morgan Stanley has had a connection to Russia for many years and, in April 1994, opened a representative office. Goldman Sachs also has an office in Moscow. At end-1993, CS First Boston was the first foreign-owned securities firm to receive a full license from the Finance Ministry, giving it the right to be a market maker, underwrite and place securities. A Swedish-owned firm, Brunswick Securities, is also licensed by the Finance Ministry. Salomon does offshore trading in Russian debt, as does Paine Webber, which also runs an investment fund in Russia. At least two joint venture firms with U.S. ownership interests are active, Troika Dialog, a subsidiary of Dialog Bank, and Active, Inc., a subsidiary of the U.S. firm Steinhardt Fund Management. Commercial banks are also allowed to engage in the securities business. To date, foreign-owned banks have not been active, but are interested in getting into the custody business.

The major activities of foreign-owned financial institutions in the Russian market include: trading offshore in external government debt; project financing; buying and trading Russian equity shares of newly privatized enterprises as agent or on own account; investment banking (e.g., assisting in mergers and acquisitions, restructuring, venture capital, financial advisory); and private client portfolio management.

TREATMENT OF FOREIGN-OWNED FINANCIAL INSTITUTIONS

With the exception of the limits facing foreign-owned banks described in the banking chapter on Russia, there is no apparent discrimination in the securities area. The Finance Ministry proposed a provision in its draft of the new securities law that would give broad latitude to regulators to impose discriminatory measures against foreign-owned securities firms, but the future of that particular draft is unclear. No foreign-owned securities firms (except joint ventures) are official dealers for government securities, but there are no rules against them becoming so. The criteria appear open and transparent and allow for the possibility for wholly owned foreign financial institutions to become members, once they have been in business for a longer period of time. The only disadvantage that foreign-owned official dealers may face is that their primary clientele, foreign investors, may only buy up to 10 percent of an official dealer's total purchase at any one T-bill auction.

FINANCIAL MARKET DISCUSSIONS

There are no formal financial market discussions with Russia. Bilateral and multilateral donors are advising the Russian government on the development of the Russian securities market. The U.S. Agency for International Development, the International Finance Corporation, and the European Bank for Reconstruction and Development are focusing on the creation of shareholder registries; creation of registrar agents; depositories/clearing and settlement organizations; support for the Russian SEC; and legislative drafting to address SROs, stock exchanges, issuance procedures, and trading.

Summary of Securities Market Participants in Russia

Non-Government Participants

Commercial banks: regulated by the CBR.
Broker-dealers: regulated by the Finance Ministry.
"Multi-functional financial services firms": firms that engage in fund management, indirect deposit taking, brokerage dealing, and/or custodial/registry services.
Stock exchanges: regulated by the Finance Ministry.
Commodity exchanges: regulated by the Anti-Monopoly Committee, trade equities, bearer securities, currency futures (and formerly vouchers); in some of the largest, commodity trading represents less than 10 percent of total trading.
Currency exchanges: regulated by the CBR, the largest also serves as the primary and secondary market for government securities.
Voucher investment funds: similar in concept to a U.S. mutual fund, but instead of selling its shares to the public, exchanged them for privatization vouchers during the privatization program, which it used to purchase shares at privatization auctions that were licensed and regulated by GKI. At the end of 1993, there were over 600 registered voucher funds.
Private investment funds and venture capital funds: includes the Framlington Group ($65 million), Flemings, PaineWebber/OPIC ($100 million), Pioneer ($100 million), New Star ($20 million) and others.
Public sector sponsored regional venture funds and enterprise funds: includes the $340 million Russian-American Enterprise Fund, the $100 million Fund for Large Enterprises in Russia, and other regional venture funds established by the G-7 countries and the international financial institutions.
Registrars, depositories, custodians.
Non-government pension funds: 571 have been registered by the Ministry of Social Protection as of October 1, 1994.
Insurance companies
Investment Companies

Government Participants

Ministry of Finance
Central Bank of Russia (CBR)
State Committee for the Management of State Property (GKI)
State Property Fund
Russian Federation Commission on Securities and Stock Exchanges (RFCSSE)

Anti-Monopoly Committee
Ministry of Social Protection
Ministry of Economy

Summary of Securities Market Instruments in Russia

Non-Government Securities

vouchers: 150 million privatization vouchers issued to the Russian population; trade at market prices for shares in privatizing companies, exchange for shares in voucher investment funds, or sell for cash.

common shares: mostly bank-issued; account for about 30 percent of trading on the regional exchanges, but only 1 percent on the Moscow exchanges, though changing; on the Central Russian Universal Exchange, up to 5 percent of total trades in early 1994 and 30 percent in April 1994 as the exchange gets ready for the demise of vouchers.

bearer securities (deposit certificates): issued in paper form by companies, not recorded in shareholder registers; face problems of theft, counterfeiting, processing, clearing, and settlements.

currency futures

commodity futures

corporate debt

debt-equity hybrids

other hybrids: corporate issues denominated in rubles, with dividends payable in dollars.

promissory notes: issued by banks and nonbanks (the latter, like commercial paper, unsecured), very short-term.

Government Securities

T-bills: both 3- and 6-month maturities; discounted paper, denomination Rbs 100,000; tax exempt; banks may use as required reserves; auction the third Tuesday of each month; only official dealers may purchase in the primary market or trade in the secondary market.

long-term (30 year) government debt: more than Rbs 30 billion issued in 1993, denomination Rbs 10,000, with 15 percent per annum coupon; no real secondary market exists.

government promissory notes: as of April 1994, Rbs 500 billion issued (expect Rbs 1.1 trillion in 1994), only 4 percent per annum, but can be used as required reserves; trading on the secondary market.

municipal debt

gold certificates: 1 year futures instrument issued against 100 tons of gold, equivalent to about Rbs 1 trillion; each certificate redeemable for 10 kilograms of gold; 10 banks authorized to deal; secondary market has formed, as banks split certificates into zero coupon claims against 100 grams of gold.

VEB loans

VEB dollar bonds: domestic, issued against $7.9 billion of frozen hard currency deposits; 5 tranches of maturities (1994, 1996, 1998, 2003, 2008), with denominations of $1,000, $10,000, and $100,000, 3 percent per annum coupon; all $500 million of first tranche was redeemed in full May 14, 1994.

TURKEY

BANKING

SUMMARY

State-owned banks are the predominant financial institutions in Turkey's banking system. They controlled over 60 percent of bank deposits at the end of 1992. In addition, state-owned institutions have a monopoly on transactions of state-owned enterprises and on governmental transfer payments. This provides them with an important advantage over private banks. However, state-ownership also brings with it a reduction in flexibility in business decisions.

There are 20 foreign banks currently operating in Turkey, including three from the United States. These institutions account for a very small share of bank deposits and loans. The U.S. banks' share is less than 1 percent.

Establishment of a bank in Turkey requires a high level of capital (approximately $32.5 million) that tends to discourage new foreign bank entry. This requirement is particularly burdensome because it applies equally to branches and to subsidiaries of foreign banks. The potential for a deterioration in the dollar value of investments in the face of rapid devaluation of the Turkish Lira and chronically high inflation rates amplifies the deterrent effect. The operations of direct branches are further constrained because lending limitations are based on local, not parent, capital.

DESCRIPTION OF THE MARKET

Banking System

There are five types of banks active in Turkey: state deposit, private deposit, branch offices of foreign banks, investment and development banks. The sector is dominated by state-owned banks, which held 61.4 percent of all bank deposits in 1992.

Six public sector banks, Ziraat, Emlak, Halk, Vakif, Etibank, and Sumerbank accounted for 37 percent of the total assets of the banking sector at the end of 1993. Their share of the market has increased in 1994 as Turks have pulled out of smaller, private sector banks perceived to be less sound.

In addition to the perception that they have the strongest government support, the state-owned banks have the advantage of size, which derives from the market penetration their branch networks provide. Ziraat Bank, for example, is frequently the sole financial institution operating in Turkey's smaller towns. Ziraat has 1,283 branches. The largest private sector bank, Akbank, has 585 branches. Ziraat possesses a near monopoly on financial transactions outside of Turkey's larger markets.

State-owned banks also have a significant advantage in their large, stable deposit base. State banks handle transactions of state economic enterprises and make transfer payments for the Turkish Treasury. This access to government funds is a huge plus for their balance sheets. On the other hand, state-owned banks are likely to face more limitations on their ability to make business decisions, e.g., closing down a large number of branches or reducing employment.

Supervision

Decree 512, issued on November 23, 1993, provides the regulatory framework for Turkey's banking sector. The Turkish Government issued this decree to bring the banking sector into greater harmony with European Union regulations in anticipation of Turkey's entry into the European Customs Union in 1995. Turkey's Supreme Court annulled the decree in December 1993, arguing that it was unconstitutional for the Prime Minister to bypass the Turkish Parliament in promulgating broad decrees. The Supreme Court allowed the decree to remain in force for six months to enable the government to pass new banking legislation.

Decree 512 was superseded by Decree 538 on June 22, 1994. The new banking law is almost identical to Decree 512. Decree 538, however, raises capital requirements for the establishment of all banks to 1 trillion Turkish Lira ($32.5 million) and tightens regulations concerning transparency in the ownership of banks. Decree 538 also establishes accounting regulations, including an external auditing requirement; establishes the Savings Deposit Insurance Fund; and limits the ability of banks to lend to their subsidiaries without notifying the Treasury and the Central Bank concerning the terms and conditions of their credit. Both decrees also limit the amount of a bank's assets that can be loaned to a subsidiary to 10 percent. Under the new Decree, the Treasury is provided with the power to intervene in the case of insolvent banks, as well as holding shareholders with more than 5 percent interest in a failed bank potentially liable for any liabilities.

All deposit banks in Turkey are required to participate in the Savings Deposit Insurance Fund. Moreover, to counter capital flight out of the banking sector, the Prime Minister announced in mid-April that every deposit account in a Turkish bank, whether Turkish lira or foreign exchange, would be fully guaranteed by the Turkish Treasury. This guarantee did not apply retroactively to the three Turkish banks that failed in March 1994.

The Central Bank of the Turkish Republic supervise bank activities in order to guarantee that banks meet liquidity requirements and operate in a responsible fashion. While the Central Bank's Bank Supervision Division acts as the government's supervisory authority, the Under-Secretariat of Treasury and Foreign Trade (UTFT) is responsible for the enforcement of banking laws. UTFT's Banking and Exchange Division conducts criminal investigations against banks and is the government agency that determines punitive actions taken against institutions violating banking or securities laws. UTFT also determines the disposition of insolvent banks.

Many of Turkey's major holding companies own banks that sometimes serve almost as company treasuries. Decree 512/538 attempts to limit borrowing by companies held by a bank's owners to no more than 20 percent.

All Turkish banks, including branches of foreign banks, must belong to the Banks Association of Turkey (Turk Bankalar Birligi). The association publishes an annual report on banking sector activities, serves as a lobby for the banking sector, and as a repository for information on Turkish banking.

Banks may currently apply for licenses as either investment banks or as deposit banks. Under Decree 512/538, Turkey moved to a single license system, similar to that which exists in the European Union. Decree 512/538 repealed earlier limitations on the opening of bank branches and merely requires that banks opening new branches inform the Treasury of their action at least 30 days prior to the opening. However, if a bank wishes to open more than 10 branches in a single year it must obtain Treasury permission. This requirement applies to local, as well as to foreign banks.

Recent Market Developments

The commercial banking sector is characterized by what some observers view as an overabundance of banks in urban areas, heavy reserve requirements, and high borrowing costs. There are 6,250 bank branches currently operating in Turkey. Given Turkey's population of 60,000,000, this means there is one bank branch for every 9,600 residents. This number is deceptive, however, because the great majority of banks are located in the industrialized Marmara region and in Turkey's three largest cities, Istanbul, Izmir, and Ankara. Few banks operate in Turkey's poor northeast and southeast regions, where savings deposits account for only 0.9 and 1.0 percent of total savings, respectively.

In 1993, the OECD calculated that borrowing costs in Turkey were 108 percent. Given the volatility of interest rates for both deposits and financial instruments since January 1994, it is extremely difficult to calculate recent borrowing costs with any degree of accuracy. However, after reaching levels of as much as 160 percent for one-month time deposits, deposits rates have recently settled around 110 percent for one-month time deposits and 130 percent for one-year time deposit accounts. Interest rates on 90-day Treasury bills briefly reached 406 percent per annum, but have now declined to around 100 percent.

In 1992 and 1993, local banks enjoyed strong profits. They benefitted from the high real interest rates offered on Turkish Government securities. At that point the Turkish lira was not depreciating rapidly enough to offset the differential between the local and foreign cost of funds. Turkish banks responded by increasing the amount of their funding in other currencies. Borrowed funds were converted into Turkish lira for placement in Turkish lira-denominated

instruments. The Under-Secretariat for Treasury and Foreign Trade estimated that the open foreign exchange position of local banks was approximately US$4.9 billion in September 1993.

A severe financial crisis began in 1994. From the beginning of the year to April 31, 1994, the Turkish lira devalued by 136 percent against the U.S. dollar and by 140 percent against the Deutsche Mark. Overnight interest rates in the month of February exceeded 350 percent, and in April the overnight rate briefly reached 1,000 percent. Banking sector analysts estimate that commercial banks may have lost as much as 10 trillion Turkish lira ($650 million) as a result of the devaluation. The high cost of funds led to a sharp contraction in commercial and consumer lending, further weakening the position of banks.

The crisis appears to have initiated a long overdue consolidation in the banking sector. Three small banks failed and were taken over by state banks. A fourth bank was sold to a large commercial bank. Many local bankers see these actions as an encouraging sign that smaller, weaker banks will ally themselves with larger institutions to insure their survival.

Given the volatility in the foreign exchange markets and high inflationary expectations, Turkish depositors began to shift their savings from Turkish lira to foreign exchange accounts. As seen in the accompanying table, between December 1992 and December 1993, the amount of foreign exchange deposits in Turkish banks increased from 118 trillion to 196 trillion Turkish lira. Central Bank officials have expressed concern over the increasing "dollarization" of the economy, noting that the Central Bank has little control over foreign exchange entering the economy. In the first months of 1994, the shift to foreign exchange has become even more dramatic. Foreign exchange accounts now account for two-thirds of all deposits in the banking system.

ATMs

One interesting development in recent years is the growing automation of the banking system. Automatic teller machines have become extremely common, as banks have closed unprofitable branches and placed ATMs in commercial areas and workplaces. The local media recently estimated that the number of ATM card holders currently exceeds 3.5 million. By comparison, the number of credit card holders is less than 2 million. Many banks have acquired information systems to increase efficiency.

U.S. PRESENCE IN THE MARKET

With a few exceptions (e.g., Osmanli Bank, Banco di Roma and Banca Commerciale Italiana), foreign banks first entered Turkey after 1980 when a number of economic reforms liberalized the local economy. The oldest foreign bank in Turkey, Osmanli Bank (established in 1863), currently operates 64 branches.

Three U.S. banks operate in Turkey: Citibank, Chase Manhattan Bank, and Chemical Bank. Citibank initiated its activities in Turkey in 1981, Chase Manhattan in 1984, and Chemical Bank in 1991. Two other major U.S. banks, Bank of America and American Express Bank, previously operated in Turkey, but their operations were acquired by Turkish companies. Bank of America sold its operations to Isbank in the late 1970s. American Express sold its remaining half interest in Koc-American Bank to Koc Holding Company in 1992. In both cases, the U.S. banks made their determination based on its assessment of business prospects.

Of the U.S. banks, only Chemical Bank operates in Turkey through a subsidiary. The other U.S. banks are branch offices of their parent institutions.
At the end of 1992, the total assets of U.S. banks operating in Turkey were 3.95 trillion Turkish lira, or 0.72 percent of the total assets of the Turkish banking system. As indicated in Table 5, in 1992 foreign banks extended loans worth 5.9 trillion Turkish lira ($859 million), totalling 2.8 percent of the total market. Market share for U.S. banks equalled only 0.53 percent in 1992.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

U.S. and other foreign banks face major disadvantages in setting up operations in Turkey. Turkey's Investment Law requires that foreign investments be made in Turkish lira. The Banking Law stipulates that to establish a bank, initial capital of at least one trillion Turkish lira (approximately $32.5 million) must be invested. This is considerably higher than the minimum capital requirement in most other countries and represents a formidable barrier to entry. Moreover, Turkish law does not distinguish between foreign bank branches and subsidiaries with respect to capital requirements.

The requirement that a large amount of paid-in capital be maintained as Turkish lira, even when the foreign bank is established in branch form, coupled with Turkey's high inflation rate, means foreign banks face the rapid erosion of their capital base. U.S. banks have requested the Turkish government to allow them to hold U.S. dollar-denominated securities to meet their capital requirement. Thus far, the government has not responded to their request.

In addition, Turkish banking law bases lending limits for branch offices of foreign banks, including those from the United States, on their local capital without taking into account their parent capital. Article 38 of Law 512/538 prohibits banks from extending credit exceeding 20 times their own funds. In the case of branch offices of foreign banks, this is interpreted to mean the assets held within the branch only.

Consolidated Balance Sheet for the Turkish Banking Sector

Assets:	November 1993	December 1992
Vault Cash	44.3	2.4
Deposits with Other Banks	125.6	92.0
Securities Portfolio (Net)	89.2	62.0
Required Reserves	48.8	30.7
Loans	407.2	231.5
Past Due Loans	13.2	8.1
Less Specific Reserve for Loans	6.6	4.8
Past Due Loans (Net)	6.6	3.2

Interest and Inc. Accruals	88.8	29.7
Bonds Held As Legal Reserves	3.7	2.1
Equity Participations	15.2	11.4
Fix Assets (Net)	23.5	18.0
Prepaid Taxes	.6	.4
Other Assets	101.5	47.0
Total Assets	955.1	550.6
Liabilities:		
Deposits	458.2	305.7
Loans Used	159.6	84.7
Funds	27.7	17.2
Import Deposits and Transfer Orders, Taxes, Duties, Charges and Premiums	5.0	6.2
Interest and Expense Accruals	35.4	17.4
Bonds	41.2	15.7
Reserves	5.4	3.5
Deferred Taxes	.04	.05
Other Liabilities	138.8	46.5
Total	874.7	499.5
Paid-Up Capital	33.1	21.6
Legal Reserves	7.4	3.8
General Reserves	4.4	2.0
Profit (Loss) for Period	27.6	14.3
Profit (Loss) Carried Over	(.2)	(.5)
Fixed Asset Revaluation Fund	8.1	9.8
Total Equities	80.4	51.1

Total Liabilities	955.1	550.6
Contingent Liabilities	303.3	162.7
Commitments	170.5	58.9
Total — Contingent Liabilities + Commitments	473.8	221.6

Source: Turkish Central Bank.
Note: All figures in Turkish lira trillions. Turkish lira average exchange rate for 1992 was 6,887 Turkish lira to 1 U.S. dollar, for 1993 the average rate was 10,985 Turkish lira to 1 U.S. dollar.)

Banking Sector Financial Aggregates
(Unless otherwise noted, these figures do not include holdings or activities of Turkey's development banks)

Deposit Banks	Dec. 1993	Dec. 1992
Vault Cash	8.7	4.9
Treasury Bonds	10.8	8.9
Government Bills	71.6	38.9
Total Deposits	228.6	155.1
Total Bank Credits	266.8	137.7
Foreign Exchange Deposits	191.7	104.8

Source: Turkish Central Bank

Currency Structure of Deposits

	Dec. 1993(*)	**Dec. 1992**
Turkish Lira	251.3	182.4
Foreign Currency	196.4	118.0
Total Deposits	461.8	300.4

* Interbank deposit figures unavailable.
Source: Turkish Central Bank

Total Assets by Bank Type		
	Assets (1992)	Sector Share
Public Banks	238.8	46.3
Commercial Banks	260.6	50.5
Foreign Banks	16.7	3.2

Loans by Bank Type		
	Loans (1992)	Sector Share
Public Banks	98.2	47.4
Commercial Banks	103.2	49.8
Foreign Banks	5.9	2.8

Source: IBAR Group

Assets, Deposit, Loans, and Net Income of U.S. Banks

Assets:	TL Trillions	Sector Share (pct)
Chase Manhattan	0.87	0.16
Citibank	2.40	0.43
Chemical	0.69	0.13
Deposits:		
Chase Manhattan	0.177	0.06
Citibank	0.322	0.11
Chemical	0.117	0.04
Loans:		
Chase Manhattan	0.180	0.08
Citibank	0.742	0.32
Chemical	0.291	0.13
Net Income:		
Chase Manhattan	0.046	0.64
Citibank	0.156	2.17
Chemical	0.058	0.80

Return on Equity and Return on Assets of U.S. Banks		
Return on Equity:	**1992**	**1991**
Chase Manhattan	100.43	73.68
Citibank	102.57	95.19
Chemical	72.77	34.61
Return on Assets:		
Chase Manhattan	6.22	3.14
Citibank	10.25	13.70
Chemical	9.83	4.17

Source: Isbank

TURKEY

SECURITIES

SUMMARY

Turkey has made some progress in liberalizing both its real and financial sectors since 1980. The stock market has experienced rapid growth in recent years. However, it is unlikely to develop fully until broader economic liberalization has been completed.

Equities are traded on the Istanbul Stock Exchange (Istanbul Menkul Kiymetleri Borsasi, or ISE), and other securities on the ISE's Bond and Money Market Exchanges. The securities regulator is the Capital Markets Board. Currently, there are no futures or options markets. However, plans are being made for the eventual introduction of derivatives trading. All securities transactions must take place through a member of the ISE.

Foreign investors may freely buy and sell listed shares of Turkish companies without limit. Similarly, there are no restrictions on Turkish residents access to foreign capital markets, but Turkish investors must direct their purchases through a domestic intermediary.

U.S. and other foreign firms must establish subsidiaries to engage in securities transactions. Branches are not permitted. Once subsidiaries are established, they are treated the same as domestic firms. However, at present, the Turkish authorities are not issuing new securities licenses to either domestic or foreign applicants.

Affiliates of three U.S. banks (Chemical, Citibank, and Chase Manhattan) are ISE members and, as such, are authorized to act as financial intermediaries in a variety of transactions. U.S. firms and pension funds are minority owners in Turkey's largest brokerage firm, Global Menkul Kiymetleri.

DESCRIPTION OF THE MARKET

Regulation

The Capital Markets Law, issued in July 1981, provides the legal framework for Turkey's financial markets. The Capital Market Board (CMB), founded in 1982, is the supervisory and regulatory agency for Turkey's financial markets. The CMB acts on the applications of firms wanting to serve as financial intermediaries and defines those activities that firms may engage in. The CMB must approve the introduction of new products. It specifies the financial instruments that may be issued locally and the means and procedures governing financial transactions. It also wields enforcement power and may ban trading by individuals and companies in the securities sector if it determines that irregularities have been committed by a financial entity. The UnderSecretariat of Treasury and Foreign Trade approves the applications of foreign companies that wish to engage in securities trading locally.

The Istanbul Stock Exchange (ISE) is a self-regulatory organization with its own regulations and disciplinary procedures. It is governed by a five-member Executive Council. The President of the Council is appointed by the government. All council decisions, however, are subject to CMB approval.

The Bond Market

High inflation and large fiscal imbalances continue to mar Turkey's economic landscape, and the Turkish government has in recent years used internal borrowing as the primary means of financing its budget deficits. Outstanding public sector debt rose to 28 percent of GNP in 1993.

Traditional instruments in the government bond market are Treasury bills (90- to 270-day terms, offered at auction) and Turkish Government Bonds (1- to 4-year terms, placed directly). Although trading in both, but especially Treasury bills, continues to dominate activity in the capital markets, the government has focused increasingly in recent years on deregulating the financial markets, increasing competition, and promoting a wider range of financial instruments in the private market beyond corporate bonds, corporate bills, commercial paper, and bank bills.

The most liquid market for investors is in government bills and bonds. The Department of the Treasury is the largest issuer in the public market (in 1993 it issued TL 173.2 trillion in Treasury bills). The secondary market for Treasury bills is particularly liquid and increasingly active, supported by an environment of high inflation, economic uncertainty, and the deregulation (in 1988) of interest rates.

Banks are the main purchasers of government securities (the latter being the instrument of choice to meet reserve requirements), followed by corporate investors, investment funds, and private investors.

Turkey's corporate bond market, established in 1986, remains relatively small. Issues of commercial paper (3-, 6-, and 9-month terms), corporate bills (360-day terms), and corporate bonds (2-year terms) are subject to CMB approval, and must be launched by intermediary banks. New issues in 1993 amounted to TL 72 trillion. The secondary market for corporate securities is created by the intermediary banks responsible for initial issues. Bank bills are borrowing instruments of the development and investment banks (these institutions do not take deposits), which also require CMB approval. In lieu of a rating system for new issues, the CMB evaluates the financial structure of the issuer, and may require a bank payment guarantee for certain securities.

The Public Participation Agency (PPA) is the government institution charged with facilitating privatization of the State Economic Enterprises (SEEs). As such, the PPA has the authority to issue revenue-sharing certificates (with 2-year terms) to finance improvement of infrastructure and the SEEs themselves (to make the latter more marketable). The Turkish government,

however, has used foreign exchange-indexed and foreign exchange-denominated revenue sharing certificates to settle outstanding debts with foreign contractors. Most contractors liquidate the certificates on the secondary market at a sharp discount from their face value.

Corporate bonds, bank bills, commercial paper, Treasury bills, and revenue-sharing certificates are traded on the ISE Bond Exchange, which opened in 1991 under the auspices of the ISE. However, the ISE Bond Exchange is not active due to certain regulatory constraints. Therefore, all bond market transactions continue to be carried out over-the-counter.

The Equity Market

Although a stock exchange first opened in Istanbul in 1866, it closed in the early years of the Turkish Republic, then re-opened in January 1986 after a hiatus of over 60 years. The ISE is a market devoted exclusively to equities trading.

The number of companies with stocks traded on the ISE has increased from 80 in 1986 to 160 by year-end 1993, and to 176 as of August 1994. Brokerage houses and banks account for about one-third of the value of traded shares, followed by telecommunications and transportation companies (about 10 percent), and cement and construction companies (about 7 percent). Total market capitalization increased from $935 million in 1986 to $37.5 billion in 1993, the latter equivalent to 21 percent of GNP.

Year-to-year performance, however, has been erratic: after posting one of the worst declines worldwide in 1992, Turkey's equity market was second only to Poland as Europe's strongest last year, reaching an all-time high of 20,683 by year-end. The ISE Composite Index (which covers 90 percent of the market) increased over 205 percent in dollars terms; turnover reached TL2,099 trillion, a 211 percent increase. Nevertheless, the market lost over 50 percent of its value in dollar terms during the first quarter of 1994.

All investors, foreign and domestic, must conduct their business through a member of the ISE. Membership on the ISE is open to foreign and domestic applicants alike, subject to certain qualifications. Banks, however, must form a separate department for capital operations in order to qualify for membership. All financial intermediaries are included as members of the Istanbul Stock Exchange, which also provides them with the right to operate in the ISE Bond Exchange. Nonmember banks may handle only over-the-counter transactions in unlisted securities.

New Products

Recent amendments to the Capital Markets Law have permitted the introduction of new financial instruments in Turkish markets, most notably the issuance of commercial paper and asset-backed securities. Other new instruments include convertible bonds and fully-open-ended mutual funds. The new law also established harsher penalties for insider trading and stricter reporting

requirements for sales of financial instruments. Decisions concerning the issuance of any new securities products are made on a regular basis by the Capital Markets Board following a review of a potential issuer's application.

Fund Management

Fund management, as well as insurance services, are emerging industries in Turkey. Turkish law does not impose any restrictions on foreign management of pension funds or mutual funds, but at present, no foreign firms are active in these areas.

Futures Markets

Currently, there are no futures or options markets. The Capital Markets Board had scheduled the Gold Exchange to open in Istanbul in the summer of 1994, but postponed the opening due to this year's adverse market conditions. The board also is considering the possibility of allowing futures trading in agricultural commodities and the introduction of financial derivatives.

Capital Controls

Nonresidents have access to Turkish securities without limit. Likewise, Turkish residents have access to foreign securities without limit. Turkish law is designed to attract foreign investment specifically into Turkey's financial markets.

There are no restrictions on foreign investment activities, either individual or institutional: a foreign national may purchase the shares of a Turkish company listed on the ISE and may freely sell these shares and repatriate dividends and proceeds without any government approval. However, in order to exercise voting rights the investor must first obtain the approval of the government authorities. Foreign investors account for an estimated 30 to 40 percent of average daily trading volume on the ISE.

The issuance and sale of securities abroad by Turkish residents is not restricted. Similarly, the issuance and sale of securities in Turkey by nonresidents is not subject to discriminatory restrictions. Turkish investors may purchase securities, including mutual funds registered on foreign exchanges through ISE members.

New Entrants

Although the Turkish government has not officially announced that it will not issue any more new securities licenses, it has not issued a new license in almost two years. Unofficial explanations suggest that at present, the Turkish government considers the number of financial intermediaries to be sufficient given the size of Turkey's securities markets.

U.S. PRESENCE IN THE MARKET

The securities affiliates of three U.S. banks, Chemical, Citibank, and Chase Manhattan, are currently listed as ISE members and are authorized to act as financial intermediaries in a wide variety of transactions.

Turkey's largest brokerage firm, Global Menkul Kiymetleri, handled 3.65 percent of ISE transaction in 1993. It is partially owned by several American firms and pension funds. The ISE reported that Chemical Bank was one of the 25 most active members in the repo-reverse repo market in 1993, with an 0.88 percent share of the market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Under the 1954 "Turkish Law Concerning the Encouragement of Foreign Capital (No. 6224)," foreign investors and businesses are granted the same rights, exemptions, and privileges granted to local investors and institutions.

Decree Number 32, issued in August, 1989, provides for the entry and repatriation of capital, dividends, and capital gains without exchange controls or restrictions. Foreign institutions that wish to directly involve themselves in the management of a local company, however, must register their investments under the Foreign Capital Law.

Foreign companies that wish to engage in securities trading locally must establish a subsidiary and meet local capital requirements. The UnderSecretariat of Treasury and Foreign Trade approves such applications. Currently, the Turkish government is not issuing new licenses for either foreign or domestic firms. Both foreign or domestic firms can obtain whole or partial ownership of an existing securities company, however. Seats on the Istanbul Stock Exchange are open to all authorized security traders, domestic and foreign.

APPENDIX I — LEGISLATIVE MANDATE FOR 1994 REPORT

The Omnibus Trade and Competitiveness Act of 1988
Subtitle G - Financial Reports

SEC 3601. SHORT TITLE

This subtitle may be cited as the "Financial Reports Act of 1988."

SEC 3602. QUADRENNIAL REPORTS ON FOREIGN TREATMENT OF UNITED STATES FINANCIAL INSTITUTIONS.

Not less frequently than every four years, beginning December 1, 1990, the Secretary of the Treasury, in conjunction with the Secretary of State, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities Exchange Commission, and the Department of Commerce, shall report to the Congress on (1) the foreign countries from which foreign financial services institutions have entered into the business of providing financial services in the United States, (2) the kinds of financial services which are being offered, (3) the extent to which foreign countries deny national treatment to United States banking organizations and securities companies, and (4) the efforts undertaken by the United States to eliminate such discrimination. The report shall focus on those countries in which there are significant denials of national treatment which impact United States financial firms. The report shall also describe the progress of discussions pursuant to section 3603.

SEC 3603. FAIR TRADE IN FINANCIAL SERVICES.

(a) DISCUSSIONS - When advantageous the President or his designee shall conduct discussions with the governments of countries that are major financial centers, aimed at:

(1) ensuring the United States banking organizations and securities companies have access to foreign markets and receive national treatment in those markets;

(2) reducing or eliminating barriers to, and other distortions of, international trade in financial services;

(3) achieving reasonable comparability in the types of financial services permissible for financial service companies; and

(4) developing uniform supervisory standards for banking organizations and securities companies, including uniform capital standards.

(b) CONSULTATION BEFORE DISCUSSIONS - Before entering into those discussions, the President or his designee shall consult with the committees of jurisdiction in the Senate and the House of Representatives.

(c) RECOMMENDATIONS - After completing those discussions and after consultation with the committees of jurisdiction, the President shall transmit to the Congress any recommendations that have emerged from those discussions. Any recommendations for changes in United States financial laws or practices shall be accompanied by a description of the changes in foreign financial laws or practices that would accompany action by the Congress, and by an explanation of the benefits that would accrue to the United States from adoption of the recommendations.

(d) CONSTRUCTION OF SECTION - Nothing in this section may be construed as prior approval of any legislation which may be necessary to implement any recommendations resulting from discussions under this section.

APPENDIX II — ACKNOWLEDGMENTS

The 1994 National Treatment Study is the fifth report of its kind and the largest undertaking yet. It is the broadest in scope in terms of geographical coverage, its description of individual banking and securities markets, and its range of international financial services issues covered. As was the case in preparation of the 1990 Study, there were no full-time staff members assigned exclusively to its preparation.

The Office of the Assistant Secretary of the Treasury for International Affairs (OASIA) had overall responsibility for the preparation of the report. The Office of the Comptroller of the Currency (OCC) had primary responsibility for the editing of the banking chapters and was responsible for the production of the final printed version of the Study. The Department of State, particularly Embassy officers in overseas-posts, played a key role by producing the initial drafts of the country/region chapters. Several other departments and agencies also contributed substantially, including: the Federal Reserve Board (FRB); the Securities and Exchange Commission (SEC); the Commodity Futures Trading Commission (CFTC); the Federal Deposit Insurance Corporation (FDIC); and the Department of Commerce.

Private Sector

On September 14, 1993, a notice appeared in the *Federal Register* soliciting public comment on significant denials of national treatment to United States banking organizations and securities companies in overseas-markets. Extensive information was provided on the banking and securities markets of numerous countries by the Bankers' Association for Foreign Trade and the Securities Industry Association. Also, the Investment Company Institute provided information on conditions in several overseas markets. Other contributors included: Cantor Fitzgerald, Fidelity Investments, and International Business Enterprises, Inc. In addition, representatives of many U.S. financial services firms located abroad were consulted by U.S. Embassy officers during the preparation of the draft chapters.

Foreign Governments

The banking and securities authorities in the countries or regions included in this report were provided an opportunity to comment on the relevant chapters and, in many cases, were requested to provide background information during the drafting of the chapters. Their comments were particularly valuable in confirming the accuracy of the descriptions of the markets under their supervision.

U.S. Government

National Treatment Study editors estimate that over 100 U.S. government employees contributed to the preparation of the 1994 National Treatment Study.

United States Embassies, Missions, and Posts

The Economic Sections, or, where available, Treasury Attache offices, of United States Embassies and Missions produced the initial drafts of the country/region chapters included in Section III of the Study. This process began in February 1994 and continued until the beginning of November. Along with writing the initial versions of the chapters, Embassy officers were called upon throughout the Report's preparation to respond to Washington editors' requests. The unique situation of overseas posts, including their knowledge of local market conditions and access to host government officials, was an invaluable resource.

The following lists the principal overseas authors of the Chapters:
Scott Danaher, Argentina; Steve McGann, Australia; Ronald Roberts, Belgium; Shari Villarosa, Brazil; Robert Watts, Canada; James Dudley, Chile; Evan Hough, China; Donald McNally, Columbia; Kevin Lindsey, Czech Republic; Mervat Tawfiq, Egypt; Peter Chase, Todd Crawford and Gregory Berger, EU; Basil Scarlis and Jock Whittelsey, Greece; Christopher Marut, Hong Kong; Charles English, Hungary; Curt Stone, India; Dan Clune, Indonesia; Gay Hoar, Italy; John Weeks and Matthew Goodman, Japan; Mary Hanson and Daniel Grant, Korea; Daniel Geisler, Malaysia; Jessica Webster, Mexico; Elizabeth Dibble, Pakistan; Sam Watson, Philippines; Jonathan Mueller, Poland; James McGlinchey, Portugal; William Murden, Russia; Bruce Levine and Anne Galer Ryan, Singapore; Joseph Sala, South Africa; David D. Nelson, Spain; Eric Madison, Taiwan; John Andre, Thailand; Ric Roberto, Turkey; Pamela Scheffler, Venezuela; Dr. Helmut Janota, Austria; Robert Boehme, Finland; George T. Boutin, Norway; Kenneth H. Kolb, Sweden; L. Allen Nelsen, Switzerland; Sara Paulson, France; Laure Redifer, Germany; William Crane, Netherlands; and William McFadden, U.K.

State Department

Eric Benjaminson and Michael Mozur of the Office of Monetary Affairs of the State Department played a key liaison role between Washington editors and drafters in the field. This included participation in the preparation and transmittal of instruction cables and generally facilitating communications between Washington and overseas posts.

Treasury Department

At the policy level, the study was conducted under the direction of Lawrence Summers, Under Secretary for International Affairs. Jeffrey Shafer, the Assistant Secretary for International Affairs and Timothy Geithner, Deputy Assistant Secretary International Monetary and Financial

Policy both reviewed key chapters in the Report and provided guidance and comment on the preparation of the Executive Summary.

The Office of International Banking and Securities Markets of the Treasury Department was involved in all phases of the project from beginning to end. The position of Office Director was shared during the preparation period by James Ammerman and John Weeks, who had overall responsibility for the direction of the project. William Quinn was responsible for the overall day to day coordination of tasking, editing, internal clearances, and the meeting of deadlines for submission of the report. He had lead responsibility for writing the Preface, Executive Summary, and the final version of the Synopsis section of Part III of the Study. He and Richard Zechter shared primary responsibility for editing of the securities chapters. Kathleen Byrne assisted with the editing of a number of the securities chapters. Richard Zechter coordinated the preparation of the chapter on "Operations of Foreign Financial Institutions in the United States" and provided substantial input. Enslow Bolden provided data tables for this chapter. Susan Hart coordinated the preparation of and contributed to the chapter on "National Treatment Under U.S. Laws and Regulations." Monica Triplett had responsibility for entering editorial changes, insuring consistency in formats, and keeping the computer files current during the project's critical final phase. During the summer of 1994, Joshua White, a volunteer student intern, made an important contribution to establishing a computer filing system that greatly facilitated preparation of the report.

Treasury Department Desk Officers and regional Office Directors were asked to undertake initial editing of the submissions from the posts, and their expertise and views were periodically sought throughout the project. These included for: South America; Bruce Juba, Rachael Bayly, Barbara Geiser Derek Hill and Katherine Parkinson; Asia and Near East; Meg Lundsager, Robert Anderson, Lawrence Dwight, Ethel McKoy, Todd Schneider and Alison Shelton; South Africa; Margie Rauch: Easter Europe and Russia; Steven Canner, Mark Sobel, Steven Altheim, Juhan Jaakson and Wesley McGrew; European Economic Area; Barbara Holloway, Richard Johnston, Miranda Otradovsky and Susan Rzmien.

Todd Crawford and Ida May Mantel of the Office of International Financial Services negotiations of the Treasury Department drafted the chapter on the Uruguay Round and provided advice on various other chapters in the report.

Llewellyn Pascoe of the Office of North American Economies of the Treasury Department drafted the chapter on the North American Free Trade Agreement and assisted in the final editing of the Canada and Mexico chapters.

Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency was actively involved in the preparation of the banking chapters throughout the project. Arthur McMahon and Howard Blacker, of the International Banking and Finance Department of the Office of the Comptroller of the Currency, assumed the primary responsibility for editing the banking chapters, under the overall guidance of Jon Hartzell, Deputy Comptroller, and Timothy Sullivan, Director. They worked with Embassy officers, Treasury desk officers, and other staff members of the International Banking and Finance Department, and drew on other sources of information. The Office of the Comptroller of the Currency also had responsibility for the information on banking included in the Synopsis section of Part III and for reviewing the Executive Summary. Raija Bettauer, Counselor for International Activities, provided legal analysis.

Claire Emory of OCC's Communications Division was responsible for the final editing of the report and oversaw its printing.

Other Departments and Agencies

Employees of several departments and agencies provided written contributions for the chapters on National Treatment Under U.S. Laws and/or Operations of Foreign Financial Institutions in United States. Others commented on the country chapters:

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